Loyola of Los Angeles Law Review

Volume 9
Number 4 *California's New General Corporation Law: A Symposium*

Article 4

9-1-1976

Distributions to Shareholders under the New California General Corporation Law

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DISTRIBUTIONS TO SHAREHOLDERS UNDER THE NEW CALIFORNIA GENERAL CORPORATION LAW

*by Gilbert Dreyfuss**

I. INTRODUCTION

A major change effected by the recent revision of the California General Corporation Law (GCL)[1] is in the treatment of dividends to shareholders and purchases and reacquisitions by a corporation of its own shares.

The statutory pattern of the prior law regulated such transactions by reference to "earned surplus," "paid-in surplus," "reduction surplus," and "stated capital," and prohibited such transactions in general language where they would cause the corporation to be unable to meet its debts and liabilities as they mature. The prior law also prescribed a statutory pattern for dividends that differed from the pattern for the purchase and redemption of shares, although the effect on the corporation might be identical.

The GCL has a single statutory pattern for dividends and purchases and reacquisitions of shares under the definition "distribution to its shareholders." It retains a general prohibition against distributions expressed in terms of insolvency, *i.e.* being unable to meet debts and liabilities as they mature, and permits distributions to the extent of "retained earnings," as that term is used in generally accepted accounting principles (GAAP). But, in the absence of retained earnings, the GCL will allow distributions only if a corporation meets certain specific balance sheet ratio tests, a major change from the prior law.

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1. Division 1 of Title 1 of the Corporations Code, *as amended*, by Laws of Sept. 12, 1975, ch. 682, § 7, [1975] Cal. Stat. — [hereinafter cited as GCL]. Amendments to the GCL have been recently enacted by the technical amendments bill, August 27th, 1976, ch. 641, [1976] Cal. Stat. —. This article will reflect all of the recently enacted technical amendments where relevant. The term "prior law" in this article refers to the General Corporation Law as in effect prior to January 1, 1977, CAL. CORP. CODE ANN. § 1 *et seq.* (West 1955) [hereinafter cited as prior law].

The concept of "stated capital" is gone from the GCL. The terms "paid-in surplus" and "reduction surplus" are also gone. Indeed, the word "surplus" has been eliminated. The new law gives us a new set of rules, following in large measure the application of GAAP in the determination of retained earnings, and imposing two pragmatic, if not severe asset-to-liability ratios for distributions in excess of retained earnings. The core sections related to shareholder distributions are contained in Chapter 5 of the new law, entitled "Dividends and Reacquisitions of Shares," sections 500 to 510. But before turning to the GCL, the prior law, which will remain in effect until January 1, 1977, will first be considered.

II. THE STATUTORY PATTERN UNDER THE PRIOR LAW

A. *In General*

The fundamental limitations on distributions to shareholders are derived from the requirement that minimum corporate capital be provided for the primary protection of creditors and for the secondary protection of shareholders.[2] The minimum capital requirement was deemed to be essential in order for shareholders to claim the limited liability afforded by the corporate entity. The concept "stated capital" in the prior law[3] set the legal minimum which could not be impaired by distributions to shareholders.

Stated capital was the aggregate par value of all of the issued shares having par value, and that portion of the consideration received in the issuance of shares without par value not allocated to paid-in surplus. Stated capital also included such other amounts transferred thereto by the declaration of stock dividends, or by transfers from a surplus account by the action of the board of directors.[4]

However, it was clear that the mere existence of stated capital did not afford any meaningful creditor or shareholder protection. The statutory pattern did not set any minimum stated capital, whether by amount or by relationship to liabilities, consistent with the needs of the business. Accordingly, if liability were to be imposed for "thin capitalization," *i.e.* the failure to maintain adequate capital for the protection of creditors, that liability was imposed without reference to any statutory guidelines.[5]

2. H. BALLANTINE, CORPORATIONS 570-72 (1946).
3. Prior law, *supra* note 1, § 1900.
4. *Id.* §§ 1900, 1903.
5. Automotriz Del Golfo De Calif. v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957).

General corporate practice called for the issuance of shares with a minimum par value (often $1 per share), with an issue price substantially in excess of par value, and with all amounts in excess of par value credited to paid-in surplus.[6] The existence of such a surplus account as a legal measure of shareholder distributions convinced sophisticated creditors and holders of senior securities that the protection they needed could not be found in the California statute and would have to be imposed by contract. Such contractual limitations often were keyed to the maintenance of conservative ratios between assets and liabilities, and to the maintenance by the corporation of a minimum shareholder equity *i.e.*, the excess of total assets over total liabilities, also referred to as "net assets."

The prior law did make a distinction among the various surplus accounts, representing an excess of net assets over stated capital. The first category of surplus was "earned surplus," not defined as such in the prior law, but which has had a general meaning under GAAP as the earnings retained in the business, or the balance thereof, as of the particular balance sheet date.[7] The second category was "paid-in surplus," which included the consideration received in excess of par value where par value shares were issued,[8] and that portion of the consideration received in the sale of shares without par value credited to paid-in surplus by designation of the board of directors.[9]

A third category of surplus under the prior law was "reduction surplus," which resulted from the reduction of stated capital[10] pursuant to the vote of the board of directors approved by a majority of all outstanding shares.[11]

Stated capital could be increased from time to time by (1) the issuance of additional shares for new consideration, (2) by transfers from earned surplus, either by the action of the board of directors or by the issuance of share dividends,[12] (3) by transfers from paid-in surplus,[13] and (4) from a reversal of reduction surplus.[14]

6. Prior law, *supra* note 1, §§ 1100, 1900.
7. CCH FINANCIAL ACCOUNTING STANDARDS, Acc't. Terminology Bull. No. 1, ¶ 66, at 3017 (1976) [hereinafter cited as FINANCIAL STANDARDS].
8. Prior law, *supra* note 1, § 1901.
9. *Id.* § 1901(b).
10. *Id.* § 1906.
11. *Id.* § 1904.
12. *Id.* §§ 1504(a), 1900(c).
13. *Id.* §§ 1504(b), 1900(c).
14. *Id.* § 1900(c).

Distributions to shareholders from reduction surplus were limited in one respect that did not apply to distributions from earned surplus or from paid-in surplus. Section 1907 of the prior law prohibited a distribution from reduction surplus

> unless the board of directors determines that . . . the assets of the corporation after such distribution or withdrawal at their fair present value will at least equal one and one-quarter times its debts and liabilities.[15]

This balance sheet test—assets required to be equal to one and one-quarter times liabilities after the distribution—can also be expressed as a requirement of a debt-to-equity ratio of four-to-one.[16] Combined with the general stricture against distributions which would render the corporation insolvent, section 1907 actually provided some creditor protection in a distribution charged against reduction surplus. The concept of section 1907, expressed in a somewhat different form, is a material part of the GCL.

In general, however, the statutory pattern under the prior law proceeded from the division of the equity section of the balance sheet into its compartments: stated capital, earned surplus, paid-in surplus, and reduction surplus, and was not related to balance sheet ratios or to the realities of corporate finance. Ultimately, the essential statutory safeguard under the prior law was the prohibition against distributions to shareholders if the corporation would be rendered insolvent in the equity sense, *i.e.*, that it would be unable to meet its debts and liabilities as they matured.[17] The insolvency limitation was particularly necessary under the prior law, since many corporations insolvent in the equity sense could otherwise make distributions to their shareholders.

B. *Dividends Under the Prior Law*

Under the prior law, dividends could be paid:

(a) out of earned surplus;[18] or

(b) out of net profits earned during the preceding accounting period of not less than six months nor more than one year, notwithstanding an

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15. *Id.* § 1907.

16. The sum of liabilities (L) plus equity (E) must by definition be equal to assets (A): $L + E = A$. If assets are equal to one and one-quarter times liabilities, then $L + E = 1\ 1/4 \cdot L$. Subtracting L from each side of the equation, $E = 1/4\ L$, from which it follows directly that $L = 4 \cdot E$.

17. Prior law, *supra* note 1, §§ 1501, 1503, 1708, 1907.

18. *Id.* § 1500(a).

existing impairment of stated capital (the so-called "nimble dividend" provision);[19] or

(c) out of reduction surplus or paid-in surplus.[20]

The source of nimble dividends, current earnings, in effect presupposed an existing capital impairment. However, the only limitation on distributions of nimble dividends was for the benefit of preferred shareholders. Where there were shareholders entitled to preferential dividends, nimble dividends could only be paid to such preferred shareholders "until the value of net assets ha[d] been restored to the aggregate amount of the stated capital attributed to outstanding shares having liquidation preferences."[21] No creditor protection was afforded, and indeed, there was insufficient preferred share protection, since dividends could be paid on common shares once the liquidation preferences of the preferred shares were covered. Moreover, there was no extra margin of safety required to protect the preferred shareholders for any subsequent losses and no protection for creditors apart from the general insolvency limitation.

A broader form of protection existed for preferred shareholders with respect to dividends from paid-in or reduction surplus. While there were shares outstanding entitled to preferential dividends, dividends from paid-in or reduction surplus could only be paid to the preferred shareholders.[22]

The prior law also contained a prohibition against a corporation paying dividends "out of the mere appreciation in the value of its assets not yet realized, . . ."[23] This rejection of appraisal increases as a source of dividends is continued (except for marketable securities) under the new law. Finally, the prior law prohibited payment of a dividend "from earned surplus representing profits derived from an exchange of assets unless and until such profits have been realized or unless the assets received are currently realizable in cash."[24] It was unclear under the prior law as to when assets received in exchange were "cur-

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19. *Id.* § 1500(b). The directors must be nimble in order to declare the dividend within the designated time, or within a reasonable time thereafter, or else lose their ability to declare it. *See* W. CARY, CASES AND MATERIALS ON CORPORATIONS 1511-16 (1969).

20. Prior law, *supra* note 1, § 1500(c).

21. *Id.* § 1500(b).

22. *Id.* § 1500(c). Notice to shareholders that distributions were being made from paid-in or reduction surplus was required. *Id.*

23. *Id.* § 1502. *See also id.* § 1505, which prohibited dividends in shares out of unrealized appreciation of assets.

24. *Id.* § 1502.

rently realizable in cash." That lack of clarity will be continued under the GCL.

C. Reacquisition of Shares Under the Prior Law

The prior law accorded somewhat different treatment to the reacquisition of shares by a corporation as compared to the payment by it of dividends, although the effect on its creditors or holders of senior securities might have been the same.

Like dividends, purchases and redemption of shares could be made out of earned surplus,[25] paid-in surplus,[26] or reduction surplus.[27] However, they could also be made from stated capital without going through the requirements imposed in distributing amounts charged to reduction surplus.[28]

Section 1706 of the prior law permitted reacquisition of shares out of stated capital to collect or compromise a claim with any shareholder,[29] to eliminate fractional shares,[30] to acquire redeemable shares at the redemption price,[31] to purchase dissenters' shares where the dissenters were entitled to the fair market value of their shares in a merger,[32] and to repurchase shares held by an employee, not an officer or director, where the corporation had retained such right by agreement.[33]

The only limitations imposed on repurchases out of stated capital permitted by section 1706 were the insolvency limitation and the requirement that the net assets remaining exceed the liquidation preferences of senior securities.[34]

Apart from the unavailability of current earnings (the source for nimble dividends) it was evident that the sources from which a corporation could reacquire shares were broader than that permissible for the payment of dividends. It was also clear that the statutory scheme did not afford effective creditor protection.[35]

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25. *Id.* § 1707(c).
26. *Id.* § 1706.
27. *Id.* § 1707(b).
28. *Id.* §§ 1906, 1907, particularly the limitation in § 1907 requiring a 1 1/4 to 1 assets-to-liabilities ratio after the distribution.
29. *Id.* § 1706(a).
30. *Id.* § 1706(b).
31. *Id.* § 1706(c).
32. *Id.* § 1706(d). Dissenters' rights were granted in prior law, *supra* note 1, § 4300 *et seq.*
33. *Id.* § 1706(e).
34. *Id.* § 1708.
35. See notes 18-24 *supra* and accompanying text.

III. The GCL's Adoption of Generally Accepted Accounting Principles (GAAP)

The GCL expressly sanctions the application of GAAP, by the enactment of section 114 which provides in part:

> 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 then applicable, and fairly presenting the matters which they purport to present, subject to any specific accounting treatment required by a particular section of this division.[36]

The actual application of GAAP in the GCL is clearly demonstrated by the elimination of the term "surplus." Accounting principles and terminology generally divide the shareholder equity section of the balance sheet into two parts: contributed capital and retained earnings. In former years, accounting practice (and the prior law) referred to retained earnings as "earned surplus" and, in former years, the contributed capital section of the balance sheet was divided into two parts generally called "capital stock" and "capital surplus."[37]

The capital stock account was the legal or stated capital consisting of the par value of par value shares or the stated value of shares without par value.[38] Capital surplus comprised all contributed capital in excess of stated capital. Included within the term capital surplus would be paid-in surplus, reduction surplus, and where permitted, appraisal surplus.[39]

In 1941, the Committee on Terminology of the American Institute of Accountants (now the American Institute of Certified Public Accountants, (AICPA)) recommended the general discontinuance of the term surplus. In 1953 the AICPA issued Accounting Terminology Bulletin, No. 1 in which the reasons for the objection to the term surplus were set forth:

> While the terms *capital surplus* and *earned surplus* have been widely used, they are open to serious objection.
>
> (1) The term *surplus* has a connotation of excess, overplus, residue, or "that which remains when use or need is satisfied" (Webster),

36. GCL, *supra* note 1, § 114.
37. Prior law, *supra* note 1, § 1500.
38 *Accord,* prior law, *supra* note 1, § 1900.
39. Financial Standards, *supra* note 7, ¶ 66, at 3017.

whereas no such meaning is intended where the term is used in accounting.

(2) The terms *capital* and *surplus* have established meanings in other fields, such as economics and law, which are not in accordance with the concepts the accountant seeks to express in using those terms.

(3) The use of the term *capital surplus* (or, as it is sometimes called, *paid-in surplus*) gives rise to confusion. If the word *surplus* is intended to indicate capital accumulated by the retention of earnings, i.e. retained income, it is not properly used in the term *capital surplus*; and if it is intended to indicate a portion of the capital, there is an element of redundancy in the term *capital surplus*.

(4) If the term *capital stock* (and in some states the term *capital surplus*) be used to indicate capital which, in the legal sense, is restricted as to withdrawal, there is an implication in the terms *surplus* or *earned surplus* of availability for dividends. This is unfortunate because the status of corporate assets may well be such that they are not, as a practical matter, or as a matter of prudent management, available for dividends.[40]

The AICPA also recommended in the same Bulletin that contributed capital be divided into two parts:

(a) Capital contributed to the extent of par or stated value; and

(b) Capital contributed in excess of par or state value.[41]

It should be noted that GAAP requires that contributed capital be divided only to comply with the legal requirements of par value or stated value (what was called stated capital under the prior law). The GCL eliminates "stated capital" and thereby eliminates the necessity for dividing contributed capital under GAAP. As a corollary to the elimination of stated capital, the concept of "par value" and "shares without par value" was also eliminated.[42] Hereafter, all contributed capital can be shown in the equity section as "capital" or "contributed capital" with a statement of the number and type of shares that comprise such capital.

In the 1953 Bulletin, the AICPA recommended that the term "earned surplus" be replaced by a term which would indicate its source, such as

40. *Id.* ¶ 67, at 3017.

41. *Id.* ¶ 69, at 3018.

42. However, if any statute or regulation imposes a tax based on capitalization, the shares are deemed to have a nominal or par value of $1 per share. And if a statute or regulation requires that shares have a par value, they will have the par value determined by the board. GCL, *supra* note 1, § 205.

retained income, retained earnings, accumulated earnings, or earnings retained for use in the business. As noted above, the GCL adopts the term "retained earnings," which is probably the most common term currently used in financial statements.[43]

It should also be noted, in determining what are the generally accepted accounting principles to be applied, that section 114 requires the use of such principles as are "then applicable." This is a recognition that accounting principles are continually evolving.

In treating a corporation which has subsidiaries, section 114 requires that references to financial statements shall mean

> consolidated statements of the corporation and such of its subsidiaries as are required or permitted to be included in such consolidated statements under generally accepted accounting principles then applicable and all references to such accounting items mean such items determined on a consolidated basis in accordance with such consolidated financial statements.[44]

A subsidiary is defined in the GCL as a corporation more than 50% of the voting power of which is owned directly or indirectly through subsidiaries by the specified corporation.[45]

Because of the requirement of consolidation, there will be cases where distributions to shareholders may be prohibited which would have been allowed on a separate accounting basis. The mere fact that a parent-subsidiary relationship exists does not always mean that a consolidated statement is required or permitted under GAAP, and attention will have to be given to GAAP to determine where it is required or permitted.[46]

IV. DEFINITION OF "DISTRIBUTION TO ITS SHAREHOLDERS"

Chapter 5 of the GCL, the core sections regulating dividends and reacquisition of shares, was designed to make no distinction between dividends and reacquisitions. Hence, the drafters classified such transactions under the single phrase "distribution to its shareholders" and so defined it.[47]

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43. GCL, *supra* note 1, § 114.

44. *Id.*

45. GCL, *supra* note 1, § 189. The 50% requirement should be compared with the 80% requirement for filing consolidated income tax returns under INT. REV. CODE OF 1954, § 1504.

46. For example, GAAP may permit the exclusion of foreign subsidiaries from the consolidated statements of United States companies. See AICPA PROFESSIONAL STANDARDS, ARB No. 43, AC § 1081.06 (1976) [hereinafter cited as PROFESSIONAL STANDARDS].

47. GCL, *supra* note 1, § 166 provides:

The GCL defines a "distribution to its shareholders" to mean a distribution of cash or property to a corporation's shareholders without consideration, including a dividend (other than a dividend in shares) and a purchase or redemption (including a purchase or redemption by a subsidiary).[48]

As noted above, Chapter 5 does not deal with dividends in shares (so-called "stock dividends"). Indeed, the accounting treatment for a dividend in shares is not specifically covered at all by the new law. The prior law did contain specific rules applicable to the issuance of share dividends[49] made necessary by the concept of stated capital. Notwithstanding the elimination of stated capital, we are still concerned with the accounting treatment for dividends in shares insofar as it transfers retained earnings to capital. Normally a dividend in shares has the effect of capitalizing retained earnings, and presumably, the accounting treatment will be governed by GAAP.[50]

Since the directors will be required to know the balance sheet condition of the corporation at the time of a distribution,[51] it is important under the new rules to know exactly *when* a distribution occurs. Section 166 provides that the time of a distribution by way of dividend is the date of declaration, notwithstanding the fact that cash or property is not transferred until a later date. The section further provides that the time of a distribution by redemption or purchase of shares is the date cash or property is transferred by the corporation. Thus, in the case of a dividend the date of declaration is critical, and in the case of redemption the date of payment is the critical date. However, if a "negotiable

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"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; provided, that where a negotiable debt security (as defined in subdivision (1) of Section 8102 of the Commercial Code) is issued in exchange for shares, the time of the distribution is the date when the corporation acquires the shares in such exchange. In the case of a sinking fund payment, cash or property is transferred within the meaning of this section at the time that it is delivered to a trustee for the holders of preferred shares to be used for the redemption of such shares or physically segregated by the corporation in trust for that purpose.

Id.

48. *Id.*

49. *See* prior law, *supra* note 1, §§ 1504-06.

50. See PROFESSIONAL STANDARDS, *supra* note 46, at ARB No. 7B, AC § 5561 and particularly § 5561.10 requiring a transfer from retained earnings to capital upon the issuance of a stock dividend.

51. *See* GCL, *supra* note 1, § 500.

debt security"[52] is given in exchange for shares, section 166 specifies that the time of distribution is the date the corporation acquires the shares. Presumably, this would be the date that the negotiable debt security is given to the shareholder in exchange for the shares.

Finally, if a sinking fund payment is required to redeem preferred shares, the distribution is deemed to be made when the cash or property is delivered to a trustee for the holders of the preferred shares, or is physically segregated by the corporation in trust for that purpose.[53]

V. Distributions To Shareholders Under the GCL

A. Distributions to Shareholders to the Extent of Retained Earnings

The GCL adopts a two fold test for distributions.[54] Distributions may be made

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52. "Negotiable debt security" does not include a simple promissory note but rather is a "security" as defined in section 8102 of the CAL. COMM. CODE ANN. (West 1972). *See* note 47 *supra.*

53. GCL, *supra* note 1, § 166.

54. GCL, *supra* note 1, § 500 provides:

> 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:
>
> (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. Paragraph (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.

Id.

(a) to the extent of retained earnings,[55] or

(b) in excess of retained earnings only if certain balance sheet tests are met after the distributions.[56]

With respect to distributions to the extent of retained earnings, the amount of retained earnings immediately prior to the distribution must equal or exceed the amount of the proposed distribution.[57] Again, the definition points out the importance of knowing exactly when the distribution is to be effective, and the importance of knowing the financial condition of the corporation at that date.

The amount of any distribution in property is to be determined on the basis of the value of such property on the corporation's financial statements, and such value is to be determined in accordance with GAAP.[58] Accordingly, a distribution of property with a fair market value of $100,000 and a book value of $10,000 requires retained earnings of only $10,000 to validate the distribution under section 500(a).

In determining the amount of the assets of the corporation, no appreciation in value not yet realized is included, except with respect to marketable securities. In effect, the GCL continues the prohibition against the use of mere appreciation in value to add to retained earnings. It also continues the prohibition against the use of assets received in exchange "unless the assets received are currently realizable in cash."[59] Exactly at what point and under what test this last phrase is to be interpreted may prove as troublesome under the GCL as under the prior law.

Marketable securities, however, may now be valued at market value, and may add to retained earnings, although the prior law gave no such permission. However, it would appear that appreciation with respect to marketable securities may only be considered if it is permissible under GAAP (although the GCL does not make a specific reference to GAAP at this particular point in the Code). It should also be noted that the AICPA has recently revised GAAP and limited the circumstances where appreciation in marketable securities may be considered.[60]

55. *Id.* § 500(a).
56. *Id.* § 500(b).
57. *Id.* § 500(a).
58. *Id.* § 500(b).
59. *Id.*
60. PROFESSIONAL STANDARDS, *supra* note 46, FASB Statement No. 12, AC § 5132.08, provides the following rule for enterprises in industries not having specialized accounting practices with respect to marketable securities: "The carrying amount of

The limitation against use of appreciation continues the prohibition contained in the prior law. As such it precludes its use under California law in a so-called "quasi-reorganization." By this device (which has limited sanction under GAAP),[61] without a formal reorganization, a corporation might write off a preexisting deficit against appraisal profits to relieve future income of the burden of making up the deficit. The GCL is clear that any deficit would have to be made up by earnings and not mere appraisal increases before retained earnings would be deemed to exist.

Not surprisingly, the new law does not authorize distributions out of current earnings when there is an existing capital impairment; nimble dividends are no longer part of the California statutory scheme.

The requirement that financial statements be prepared on a consolidated basis[62] will undoubtedly produce unexpected and unwanted results. The parent which enters into a new field through a viable subsidiary may find its retained earnings eliminated by later losses of the subsidiary in excess of its investment, notwithstanding the fact that the parent has no legal liability for such losses. The objection to consolidation was considered by the drafters, who felt that so long as consolidation was required or permitted under GAAP, retained earnings (as well as the balance sheet tests) should be determined on a consolidated basis. Relief can be afforded when it is determined that consolidation is not required or permitted under GAAP. Presumably such a result might be achievable by appropriate corporate transfers or other planning measures.

B. *Distributions to Shareholders in Excess of Retained Earnings*

If there are insufficient retained earnings under section 500(a), the distributions must qualify under two tests: the first, relating *total* assets to *total* liabilities;[63] and the second, relating *current* assets to *current* liabilities.[64]

The total asset—total liability test requires that, after the distribution, total assets are no less than one and one-quarter times total liabilities. Hence, the debt to equity ratio after distribution may not exceed four to

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a marketable equity securities portfolio shall be the lower of its aggregate cost or market value, determined at the balance sheet date." *Id.*

61. *See* PROFESSIONAL STANDARDS, *supra* note 46, ARB 43, AC § 5581.

62. GCL, *supra* note 1, § 114.

63. *Id.* § 500(b)(1).

64. *Id.* § 500(b)(2).

one.[65] It will be noted that this requirement is the same as that imposed under the prior law for distributions from reduction surplus.[66] However, under the prior law, the assets were to be valued at their "fair present value," while under the GCL, except for marketable securities, book value is the basis for valuation.[67]

The GLC is significantly stricter than GAAP in determining the balance sheet ratio. The GCL expressly provides that the sum of the assets of the corporation are to be determined "exclusive of goodwill, capitalized research and development expenses, and deferred charges."[68] This stricter asset test is moderated by excluding from liabilities "deferred taxes, deferred income, and other deferred credits."[69]

Although GAAP has recently changed its policies with respect to the accounting for intangible assets and generally requires amortization for all intangibles acquired after October 31, 1970,[70] GAAP currently does

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65. See note 16 *supra*.

66. Prior law, *supra* note 1, § 1907.

67. See note 58 *supra* and accompanying text.

68. GCL, *supra* note 1, § 500(b).

69. *Id.*

70. PROFESSIONAL STANDARDS, *supra* note 46, APB Op. No. 17, AC § 5141.27-.29, which provides in part:

> The Board believes that the value of intangible assets at any one date eventually disappears and that the recorded costs of intangible assets should be amortized by systematic charges to income over the periods estimated to be benefitted. Factors which should be considered in estimating the useful lives of intangible assets include:
>
> a. Legal, regulatory, or contractual provisions may limit the maximum useful life.
> b. Provisions for renewal or extension may alter a specified limit on useful life.
> c. Effects of obsolescence, demand, competition, and other economic factors may reduce a useful life.
> d. A useful life may parallel the service life expectancies of individuals or group of employees.
> e. Expected actions of competitors and others may restrict present competitive advantages.
> f. An apparently unlimited useful life may in fact be indefinite and benefits cannot be reasonably projected.
> g. An intangible asset may be a composite of many individual factors with varying effective lives.
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> The period of amortization of intangible assets should be determined from the pertinent factors.
>
> The cost of each type of intangible asset should be amortized on the basis of the estimated life of that specific asset and should not be written off in the period of acquisition. Analysis of all factors should result in a reasonable estimate of the useful life of most intangible assets. A reasonable estimate of the useful life may often be based on upper and lower limits even though a fixed existence is not determinable.
>
> The period of amortization should not, however, exceed forty years. Analysis at the time of acquisition may indicate that the indeterminate lives of some intangible assets are likely to exceed forty years and the cost of these assets should be amortized over the maximum period of forty years, not an arbitrary shorter period.

Id.

not require an immediate write-off of all intangibles, but instead calls for amortization over the periods estimated to be benefited. Thus, the total asset—total liability test under the GCL is much stricter than that required by GAAP, and undoubtedly will produce a substantial number of situations where funds are available for distributions, and creditors are sufficiently protected, but where the total asset—total liability test cannot be met. The wisdom of adopting a test under the GCL so much stricter than GAAP, without consideration of the value of the intangibles is questionable.

The second balance sheet test, relating current assets to current liabilities, requires that after the distribution, current assets equal current liabilities.[71] However, if the average earnings of the corporation before income taxes and interest were less than the average interest expense for the preceding two fiscal years, the current assets are required to be at least one and one-quarter times current liabilities after distribution.[72]

For the purpose of the current asset—current liability test, some of the drafters felt that the strict application of GAAP might preclude distributions in some situations when there was no real liquidity problem. Such a situation could develop because GAAP requires the inclusion in current liabilities of the portion of long-term liabilities due within one year, while the receivables that would be generated to pay the current portion of such long-term liabilities would not be included in assets. Thus, it is not unusual for public utilities or real estate companies to be sound from a liquidity standpoint and yet not be able to meet a one-to-one ratio between current assets and current liabilities.

Accordingly, the GCL departs somewhat from GAAP and for this balance sheet test current assets may include the net amount which the board of directors determines in good faith may reasonably be expected to be received from customers during the twelve-month period used in calculating current liabilities. Such amounts must be receivable pursuant to existing contractual arrangements obligating such customers (including lessees under leases) to make fixed or periodic payments during the term of the contract. In the case of public utilities, amounts to be received pursuant to service connections with customers may be considered as current assets. In each case, current liabilities would be required to be increased to reflect future costs not then included in

71. GCL, *supra* note 1, § 500(b).
72. *Id.* § 500(b)(1).

current liabilities but which would be incurred when the corporation performed its part of the contract or rendered service to its customers.

Finally, the current asset—current liability test does not apply to corporations which, under GAAP, do not classify their assets into current assets and fixed assets, such as some financial institutions. However, prudence should cause directors to question the right to make a distribution where there are no retained earnings, and where the ratio of current assets to current liabilities is less than one-to-one under the expanded definitions of the GCL, on the supposition that the particular business is not required under GAAP to divide its assets into the classification of current and fixed.

C. *Insolvency Limitation Under the New Law*

The GCL continues and slightly expands the prohibition against distributions which would cause the corporation to be rendered insolvent in the equity sense.[73] Under the prior law a distribution was prohibited if "thereupon . . . [the corporation] would be unable to meet its debts and liabilities as they mature."[74] The GCL precludes the distribution

> 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.[75]

Thus, if the corporation were insolvent prior to a proposed distribution, the distribution would be improper. It is not necessary that the distribution itself render the corporation insolvent.

With respect to a parent-subsidiary relationship, a subsidiary cannot make a distribution to its parent if the subsidiary would be rendered insolvent thereby. Such a limitation is designed to protect the minority shareholders of the subsidiary against "upstreaming" excessive distributions.[76]

Insolvency under the GCL is equated with insolvency in the equity sense of inability to pay liabilities as they mature. If a corporation were insolvent in the bankruptcy sense, (*i.e.*, if its assets were less than its liabilities), no distributions would be permitted. First, there would be no retained earnings (the assets having been written down by charges to

73. *Compare id.* § 501 *with* prior law, *supra* note 1, §§ 1501, 1708.
74. Prior law, *supra* note 1, § 1501.
75. GCL, *supra* note 1, § 501.
76. *Id.*

earnings); and second, the corporation could not meet the total asset—total liability test under section 500(b).[77]

D. Limitation on Distributions Because of Liquidation Preferences

A corporation with outstanding shares entitled to liquidation preferences, may not make any distribution to shareholders on junior shares if, after such distribution, the excess of its assets, exclusive of certain intangibles (goodwill, capitalized research and development expenses, and deferred charges), over its liabilities, exclusive of certain deferred items (deferred taxes, deferred income, and other deferred credits), would be less than the outstanding liquidation preferences.[78]

Surprisingly, this provision may prohibit a distribution to common shareholders *where there are retained earnings,* a result probably unanticipated by the drafters. This would occur if there were preferred shares outstanding and the write-off of intangibles required by section 502 were in excess of that required by GAAP. As noted above, while GAAP now requires the amortization of goodwill and other tangibles, it normally does not require an immediate write-off. Thus, under GAAP there may be retained earnings but an inability to meet the test of section 502 because the total assets, (excluding intangibles), may not be one and one-quarter times the total liabilities.[79]

E. Limitation on Distributions Because of Dividend Preferences

A corporation with outstanding shares with dividend preferences may not make a distribution on junior shares unless, after such distribution, there would be sufficient retained earnings to cover all dividends in arrears on such preferred shares.[80] This is strictly a retained earnings test and requires no determination of balance sheet ratios.

F. Additional Limitations on Permitted Distributions

Under the prior law, it was common practice for additional restrictions to be imposed by contractual agreement on the declaration of dividends and the redemption and purchase of shares. Such limitations were imposed for the benefit of creditors and holders of senior securities.

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77. *Id.* § 500(b).
78. *Id.* § 502.
79. *Id.* § 500(b).
80. *Id.* § 503.

The GCL expressly provides that nothing in Chapter 5 prohibits the imposition of such additional restrictions. Accordingly, additional limitations may be imposed under the articles of incorporation,[81] or under the bylaws,[82] or under a bond indenture or other creditor agreement.

G. *Liability of Shareholders for Improper Distributions*

A shareholder who receives a distribution prohibited under the GCL is liable if the distribution is received with knowledge of facts indicating its impropriety.[83] The liability is to the corporation for the benefit of all creditors or shareholders entitled to institute an action.[84]

The measure of the liability is the amount of the improper distribution received plus interest thereon at the legal rate applicable to judgments,[85] until paid,[86] but that liability may not exceed the liabilities of the corporation owed to nonconsenting creditors at the time of the violation, and the injuries suffered by nonconsenting shareholders.[87]

The liability of shareholders under the GCL continues the liability imposed under the prior law,[88] under which a shareholder was liable if a distribution was received "with knowledge of facts indicating the impropriety thereof." One change has been made: under the prior law, the liability of the shareholder existed if the distribution was improper under *any* provision of the General Corporation Law.[89] Under the GCL, the liability under Chapter 5 will exist only for distributions which are prohibited by Chapter 5.[90]

The limited nature of the shareholder liability is made clear if that

81. *Id.* § 204(d).
82. *Id.* § 212(b)(1).
83. *Id.* § 506.
84. *Id.* § 506(a).
85. The legal rate of interest on judgments is currently 7% per annum. CAL. CONST. art. 15, § 1.
86. Presumably, interest on the improper distribution would run from the date the distribution was received by the shareholder, but the statute is not explicit on that point. If the particular plaintiff's damages did not accrue until a later date (for example, a creditor whose obligations became due after the improper distribution), interest may not be recoverable until that later date, or perhaps may be deferred to the filing date of the litigation. *See* CAL. CIV. CODE § 3287 (West 1970).
87. GCL, *supra* note 1, § 506(a).
88. Prior law, *supra* note 1, §§ 1510, 1715.
89. *Id.* § 1510.
90. *Compare* GCL, *supra* note 1, § 506(a) ("any distribution prohibited by this *chapter*") *with* prior law, *supra* note 1, § 1510 ("any dividend not authorized by this *division*" wherein division refers to the entire General Corporation Law); *See also* Gray v. Sutherland, 124 Cal. App. 2d 280, 286, 268 P.2d 754, 759 (1954).

liabilty is stated in the negative. Under the GCL, a shareholder who receives a distribution in violation of Chapter 5 is *not* liable

(a) if such shareholder had no knowledge of facts indicating the impropriety of the distribution;

(b) for any amount in excess of the improper distribution received by the shareholder, plus interest;

(c) to any creditor or shareholder who consented to the distribution;

(d) to any creditor except for the amount of any unpaid liability at the time of the violation;

(e) to persons who became creditors after the improper distribution; and

(f) to any nonconsenting shareholder except for actual injury suffered.[91]

The GCL expressly provides that nothing therein affects the liability of shareholders which might be asserted in the name of the corporation under the Uniform Fraudulent Conveyance Act.[92]

An action to enforce shareholder liability may be brought in the name of the corporation against a shareholder who has received an improper distribution by

(a) one or more creditors whose claims which were based on violations of sections 500 or 501 arose prior to the improper distribution and who did not consent to it;[93] or

(b) one or more nonconsenting shareholders of shares outstanding at the time of the improper distribution, for claims based on violations of sections 502 or 503 without regard to the provision of the new law relating to shareholder derivative actions.[94]

A shareholder who is sued for recovery of an improper distribution may implead other shareholders who may be liable in order to compel their contribution.[95]

H. Liability of Directors for Improper Distributions

Directors who approve a distribution which violates sections 500-503 of the GCL (the basic provisions of Chapter 5) are jointly and severally liable to the corporation for the benefit of nonconsenting creditors or

91. GCL, *supra* note 1, § 506.

92. *Id.* § 506(d). The Uniform Fraudulent Conveyance Act is set forth in CAL. CIV. CODE §§ 3439-3439.13 (West 1970).

93. GCL, *supra* note 1, § 506(b).

94. *Id.*

95. *Id.* § 506(c).

shareholders.[96] However, a person who performs the duties of a director with the care specified in sections 309(a) and 309(b) of the GCL will not be liable notwithstanding the impropriety of the distribution.[97]

The standard of care required of the director in performing his duties in general is set forth in section 309(a). In performing the duties of a director, a director will of necessity rely upon information, opinions, reports, or statements of others. Such reliance is particularly necessary in determining the propriety of distributions to shareholders since a director is generally compelled to rely upon financial information supplied by others.

With respect to the general standard of care under section 309(a), the GCL provides that a director is required to perform the duties of a director (including duties as a member of an executive committee):

(a) in good faith;

(b) in a manner a director believes to be in the best interests of the corporation; and

(c) with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances.

Section 309(b) lists the persons upon whom a director may rely upon for information, opinions, reports, or statements. These persons include:

(a) one or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented;[98]

(b) attorneys, independent accountants, or other persons as to matters which the director believes to be within such persons' professional or expert competence;[99] and

(c) executive committees of the board (composed of members of the board of directors) on which the director does not serve if the director believes the committee merits confidence.[100]

In describing the particular standard of care to which a director is held in relying on others, it would have been sufficient merely to incorporate the standards set forth in section 309(a). However, section 309(b) provides its own standard of care. While the standard under

96. *Id.* § 316(a)(1).
97. *Id.* § 309(c).
98. *Id.* § 309(b)(1).
99. *Id.* § 309(b)(2).
100. *Id.* § 309(b)(3).

section 309(b) is probably not more extensive than that imposed under section 309(a), it is more precise in expressly requiring that the director be without knowledge that would cause reliance to be unwarranted. Specifically, under section 309(b), the director is entitled to rely on the information and opinions of others provided the director

(a) acts in good faith;

(b) makes reasonable inquiry when the need therefor is indicated by the circumstances; and

(c) is without knowledge that would cause such reliance to be unwarranted.

Since the director will have to determine the propriety of the dividend by reference to financial statements prepared under GAAP, the GCL will undoubtedly cause the director to rely heavily on the reports of independent accountants. Moreover, since the director is under a duty of inquiry to justify reliance, and must be without knowledge that such reliance is unwarranted, the prudent director can be expected to make a careful review of the quality of the independent accountant's work.

If a director fails to perform the duties imposed in accordance with the standards of sections 309(a) and 309(b) and approves a distribution to shareholders, and if the distribution was improper, the damages recoverable will be the amount of the illegal distribution, not exceeding the sum of the liabilities owed to nonconsenting creditors at the time of the violation and the injury to nonconsenting shareholders.[101]

A director who is sued for recovery of improper distributions may implead other directors and compel contribution.[102] If a director is liable for such improper distribution,[103] and is required to make good on such liability, the director is subrogated to the rights of the corporation against the shareholders who received the improper distribution. The director may cross-complain in the action in which the director's liability is asserted, or the director may file an independent action.[104] Thus, as between the director and shareholder, it is the shareholder who received the distribution and who would ordinarily have the liability for repayment. However, since the shareholder may escape liability because of the lack of knowledge of the impropriety of the distribution, or because the liability is limited (as discussed in the preceding section), the right of subrogation may prove to be of limited value.

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101. *Id.* § 316(d).
102. *Id.* § 316(e).
103. See notes 96-102 *supra* and accompanying text.
104. GCL, *supra* note 1, § 316(f).

As a consequence of these provisions, the liability of a director for an improper distribution is extensive, and the new rules relating to balance sheet condition will compel the directors to make a close scrutiny of the financial condition of the corporation prior to making any distributions.[105]

I. Liability of Shareholders and Directors for Improper Distributions if No One Can Bring Suit

As noted above, in dealing with the liability of shareholders and directors for improper distributions, there are only certain parties who can bring suit and there are only certain parties to whom the shareholders and directors will be liable if there is an improper distribution.[106] There may be circumstances where the distribution is improper but there is no one who may bring a cause of action. May the directors safely make and the shareholders safely receive such a distribution?

The circumstances in which such a distribution might be desired can be illustrated by considering a corporation with no retained earnings, but with substantially appreciated real property which can support a large loan in excess of the book value of that property. Assume that the lender is willing to look to the property alone for security.[107] At the time the money is borrowed, there are no other creditors. The corporation wishes to make a pro rata distribution to its shareholders. A distribution in excess of retained earnings would be improper because the total asset—total liability test cannot be satisfied, appreciation of the property being excluded from consideration.[108] However, there would be no plaintiff to bring an action under Chapter 5.[109] Under these circumstances, there should be no civil liability for making the distribution.

However, the existence of a possible criminal penalty in certain circumstances might have a chilling effect.[110] Under section 2253, a

105. The directors' liability for improper distributions under the prior law was also extensive. Prior law, *supra* note 1, §§ 824-26. *See generally* 1 H. BALLANTINE AND G. STERLING, CALIFORNIA CORPORATION LAWS, §§ 84-87 (4th ed. 1975). However, the absence of any balance sheet test (except for prior law, *supra* note 1, § 1907 relating to reduction surplus) enabled the directors to avoid liability.

106. See notes 83-105 *supra* and accompanying text.

107. By virtue of CAL. CODE CIV. PRO. § 726 (West 1972), the lender would in any event be required to foreclose the security before seeking a deficiency judgment and the limitations of sections 580a and 580d might prevent any deficiency.

108. See notes 63-70 *supra* and accompanying text.

109. GCL, *supra* note 1, § 506.

110. *Id.* § 2253 (substantially identical to prior law, *supra* note 1, § 1510) provides as follows:

director who concurs in any vote or act of the directors to make an improper distribution is guilty of a misdemeanor, but only if done with a dishonest or fraudulent purpose, and with the design of defrauding creditors or shareholders or of giving a false appearance to the value of the stock and thereby defrauding subscribers or purchasers.[111]

Returning to the foregoing illustration, and assuming the lack of fraudulent intent, it should be clear that the directors may safely make an improper distribution without fear of the criminal provision. However, the directors would have to be wary of any shareholders who purchased their shares *after* the dividend in reliance upon the dividend as giving some measure of value to the security. Although Chapter 5 gives a cause of action only to nonconsenting shareholders who were shareholders at the time the improper distribution was made, the effect of section 2253 may make it a crime if *subsequent* shareholders were deceived.

The problem of potential criminal liability for technically improper distributions, even though no existing shareholder or creditor is damaged, should be resolved by enactment of an additional provision into Chapter 5 which would permit a distribution that would otherwise be improper upon the written waiver of all shareholders and creditors.

J. Notice to Shareholders of Source of Distribution

Notice does not have to be given to the shareholders if the distribution is chargeable to retained earnings.[112] However, if the distribution is from a source other than retained earnings, the GCL requires that a notice be given to the shareholders which shall identify such distribution "as being made from a source other than retained earnings."[113] The notice must state the accounting treatment thereof. The notice is required to be given with the distribution or within three months after the end of the fiscal year in which the distribution is made.[114]

> Any director of a stock corporation, domestic or foreign, who concurs in any vote or act of the directors of the corporation or any of them, knowingly and with dishonest or fraudulent purpose, to make any dividend or distribution of assets except in the cases and in the manner allowed by law, either with the design of defrauding creditors or shareholders or of giving a false appearance to the value of the stock and thereby defrauding subscribers or purchasers, is guilty of a misdemeanor, punishable by a fine of not more than one thousand dollars ($1,000) or imprisonment for not more than one year or both.

Id.

111. *Id.*

112. *Id.* § 507.

113. *Id.*

114. *Id.* Of course, the mere fact that a shareholder receives notice that the distribution is not from retained earnings would not give the shareholder "knowledge of facts indicating its impropriety" for the purposes of section 506(a), a condition of

K. Status of Reacquired Shares—Elimination of Treasury Shares

The GCL provides that when a corporation reacquires its own shares, such shares are restored to the status of authorized but unissued shares.[115] However, if the articles prohibit the reissuance of the shares, upon their reacquisition the authorized number of shares of the class or series to which such shares belong is to be reduced.[116]

The foregoing provision of the GCL effectively eliminates treasury shares. Under the prior law, treasury shares were defined as "shares issued and thereafter acquired by the corporation, but not retired or restored to the status of unissued shares."[117]

The legal and accounting professions faced a number of conceptual difficulties in the treatment of treasury shares. If the corporation owned shares in itself, were such shares an asset? Should the shares be considered outstanding? What was the effect on stated capital? Do they share in dividends? Does the corporation realize gain or loss on their purchase and resale?

The only distinction between treasury shares and other shares reacquired by the corporation was that treasury shares were purportedly still issued—they were not restored to the status of unissued shares.[118] The only advantage, theoretical at best, was that treasury shares could be resold without complying with the consideration requirements under the prior law.[119] However, if the treasury shares were in fact sold, such resale was subject to the California Corporate Securities Law[120] and thereby subjected the sale of treasury shares to the requirement of fair consideration.[121]

In short, treasury shares represented an aberration in the statutory scheme that created unnecessary legal and accounting problems. The GCL correctly disposes of these problems by placing all reacquired shares in the status of unissued shares. The question of whether such

shareholder liability. What is of more significance to the shareholder is the income tax treatment of the distribution which would be the practical reason for the notice. Under prior law section 1500(c), a dividend from paid-in or reduction surplus must have been accompanied or preceded by a notice of source. Prior law, *supra* note 1, § 1500(c).

115. GCL, *supra* note 1, § 510(a).

116. *Id.* § 510.

117. Prior law, *supra* note 1, § 116.

118 *See generally* 1 H. BALLANTINE AND G. STERLING, CALIFORNIA CORPORATION LAW, § 159 (4th ed. 1975); FINANCIAL STANDARDS, *supra* note 7, 1 APB, §§ 5541-42.

119. Prior law, *supra* note 1, § 1109.

120. GCL, *supra* note 1, § 25109.

121. CAL. CORP. CODE ANN. § 25140 (West Supp. 1975).

unissued shares could remain *authorized* is left to the provisions of the articles of incorporation.

VI. MISCELLANEOUS PROVISIONS OF CHAPTER 5

There are certain companies that are excluded from all or some of the provisions of Chapter 5.[122] Section 500 does not apply to a dividend by a regulated investment company, as that term is defined in the United States Internal Revenue Code, if such distribution is required to maintain the status of a regulated investment company.[123] In addition, Chapter 5 does not apply to purchases or redemptions of shares by a registered open-end investment company, as that term is defined under the Investment Company Act of 1940, pursuant to unsuspended redemption rights granted to holders of the shares.[124]

The provisions of Chapter 5 relate generally to distributions which are made by corporations not in dissolution. The GCL specifically provides that Chapter 5 does not apply to involuntary dissolutions (under Chapter 18) or voluntary dissolutions (under Chapter 19).[125]

Finally, section 509 reenacts without change the provisions of the prior law which set forth the procedure for redeeming shares which are subject to redemption.[126]

VII. CONCLUSION

The California limitations on distributions represent a substantial innovation;[127] they were not in any way inspired by the Model Corporation Act.[128] The balance sheet tests are a refreshing recognition of the practicalities of corporate finance. By recognizing such realities, the GCL may be better able to give to creditors and holders of senior securities the desired protection against excessive distributions to shareholders.

122. GCL, *supra* note 1, § 504.

123. *Id.*

124. *Id.*

125. *Id.* § 508.

126. Prior law, *supra* note 1, §§ 1700-03.

127. Arkansas law contains a provision not unlike prior law section 1907 prohibiting a distribution chargeable to capital surplus if the "fair value" of remaining assets is less than 125% of liabilities. ARK. STAT. ANN. § 64-403 (1966).

Rhode Island requires the "fair value of net assets" to be no less than 25% of total liabilities after the distribution (the same as requiring total assets to be 125% of total liabilities). R.I. GEN. LAWS ANN. § 7-1.1-41 (1969).

Note that each of the statutes deals with "fair value" while California requires book value, excluding intangibles.

128. ABA-ALI MODEL BUS. CORP. ACT §§ 45, 46 (1953), the provisions of which are not dissimilar to the prior law in California.

Although the total assets—total liabilities ratio is used only for the purpose of validating distributions in excess of retained earnings,[129] its impact may extend to other areas of corporate law. The legislatively-approved balance sheet tests and ratios will certainly be considered in determining whether a corporation is subject to a "thin capitalization" attack on its corporate characteristics. By permitting assets to be taken out of the corporation in the form of distributions, the GCL seems to recognize as sufficient capitalization equity equal to one and one-quarter times the corporation's liabilities.[130] At the minimum, corporate planners should feel relatively confident that if they meet the conservative California test, they will withstand the attacks of creditors and the Internal Revenue Service.[131]

One of the most significant features of the GCL is its explicit adoption of generally accepted accounting principles, GAAP.[132] The most significant feature of the new law in dealing with distributions to shareholders is the adoption of balance sheet tests for distributions in excess of retained earnings.[133] However, the GCL has in some instances placed these two features in conflict with each other.[134]

No one should quarrel with the requirement that assets be equal to one and one-quarter times liabilities in order to permit distributions in excess of retained earnings, but the complete exclusion of intangibles from the calculation seems unnecessarily conservative.[135] GAAP does not require the immediate write-off of intangibles but instead permits amortization of the intangibles over their estimated useful life.[136] Since other assets are to be taken at book value for the purposes of the California tests, it would have been consistent with a prudent and conservative approach to allow intangibles to be valued in accordance with GAAP.

Practice under the new law will put the statute to the test. If it is unnecessarily restrictive, modifications will be in order. For the most part, however, the GCL is clearly a major improvement in the entire approach of corporate distributions to shareholders.

129. See notes 63-70 *supra* and accompanying text.
130. See notes 65-67 *supra* and accompanying text.
131. For a discussion of thin incorporation from an income tax standpoint, *see* B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, §§ 4.04-.05 (3d ed. 1971). *See also* INT. REV. CODE of 1954, § 385.
132. See note 36 *supra* and accompanying text.
133. See notes 63-70 *supra* and accompanying text.
134. See text accompanying notes 63-73 *supra*.
135. See notes 68-69 *supra* and accompanying text.
136. See note 70 *supra* and accompanying text.