

RESOLUTION 07-06-04

DIGEST

Corporate Shares: Rights of Shareholders on Redemption

Amends Corporations Code section 402 to provide that the holders of redeemable shares of a corporation become creditors of the corporation once the corporation acts to redeem the shares.

RESOLUTIONS COMMITTEE RECOMMENDATION

DISAPPROVE

History:

No similar resolutions found.

Reasons:

This resolution amends Corporations Code section 402 to provide that the holders of redeemable shares of a corporation become creditors of the corporation once the corporation acts to redeem the shares. The resolution should be disapproved because it is redundant and unnecessary.

Corporations Code section 509, subdivision (d), provides that after the corporation gives notice of redemption and deposits the purchase price of the shares, the shareholders cease to be shareholders and have only the right to receive the funds from the depository, without interest, becoming, in effect, creditors of the corporation. To add the language suggested by the resolution to section 402, a statute authorizing the issuance of redeemable shares, might be construed as creating a separate class of creditors, and appears unnecessary and redundant.

TEXT OF RESOLUTION

RESOLVED, that the Conference of Delegates recommends that legislation be sponsored to amend California Corporations Code section 402 to read as follows:

- 1 § 402
- 2 (a) A corporation may provide in its articles for one or more classes or series of
- 3 shares which are redeemable, in whole or in part, (1) at the option of the corporation or (2)
- 4 to the extent and upon the happening of one or more specified events, and not otherwise
- 5 except as herein provided. A corporation may provide in its articles for one or more classes
- 6 or series of preferred shares which are redeemable, in whole or in part, (1) as specified
- 7 above, (2) at the option of the holder, or (3) upon the vote of at least a majority of the
- 8 outstanding shares of the class or series to be redeemed. An open end investment company
- 9 registered under the United States Investment Company Act of 1940 may, if its articles so
- 10 provide, issue shares which are redeemable at the option of the holder at a price
- 11 approximately equal to the shares' proportionate interest in the net assets of the corporation
- 12 and a shareholder may compel redemption of such shares in accordance with their terms.
- 13 (b) Any such redemption shall be effected at such price or prices, within such time
- 14 and upon such terms and conditions as are stated in the articles. When the articles permit
- 15 partial redemption of a class or series of shares, the articles shall prescribe the method of
- 16 selecting the shares to be redeemed, which may be pro rata, by lot, at the discretion of, or

17 in a manner approved by, the board or upon such other terms as are specified in the
18 articles.

19 (c) No redeemable common shares, other than (1) shares issued by an open end
20 investment company registered under the United States Investment Company Act of 1940,
21 (2) shares of a corporation which has a license or franchise from a governmental agency to
22 conduct its business or is a member corporation of a national securities exchange
23 registered under the United States Securities Exchange Act of 1934, which license,
24 franchise or membership is conditioned upon some or all of the holders of its stock
25 possessing prescribed qualifications, to the extent necessary to prevent the loss of such
26 license, franchise or membership or to reinstate it, or (3) shares of a professional
27 corporation, as defined in Part 4 (commencing with Section 13400) of Division 3 of Title
28 1, shall be issued or redeemed unless the corporation at the time has outstanding a class of
29 common shares that is not subject to redemption.

30 (d) Any redemption by a corporation of its shares shall be subject to the provisions
31 of Chapter 5 (commencing with Section 500). Nothing in this section shall prevent a
32 corporation from creating a sinking fund or similar provision for, or entering into an
33 agreement for, the redemption or purchase of its shares to the extent permitted by Chapter
34 5, but unless such purchase or redemption is permitted under Chapter 5, the holder of
35 shares to be so purchased or redeemed shall not become a creditor of the corporation;
36 provided that if such redemption or purchase is permitted under Chapter 5, the holders of
37 shares so purchased or redeemed shall cease to be shareholders with respect to such shares
38 and shall have no rights with respect thereto except the right to receive payment of the
39 redemption price of the shares without interest, and become a creditor of the corporation.

(Proposed new language underlined; language to be deleted stricken.)

PROPONENT: Los Angeles County Bar Association

STATEMENT OF REASONS

Existing Law: Section 402 provides that holders of preferred shares that are redeemed or purchased do not lose their status as shareholders and become creditors of the corporation if the redemption or purchase is not permitted under Chapter 5, but implies but does not state the reverse where such redemption or purchase is permitted under Chapter 5.

This Resolution: Would expressly provide that where redemption or purchase of preferred shares is permitted under Chapter 5, such holders lose their status as shareholders and become creditors of the corporation.

The Problem: Section 402 contains a negative implication that redemptions or purchases that are permitted under Chapter 5 change the status of preferred holders from shareholders to creditors, but does not expressly so provide.

IMPACT STATEMENT

This proposed resolution does not affect any other law, statute or rule.

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COUNTERARGUMENTS

BAR ASSOCIATION OF NORTHERN SAN DIEGO

Chapter 5 limitations on a corporate redemption of stock, in essence, prevents shareholders from being paid before the corporate creditors. It does not follow that because the corporation meets the asset to liability, retained earnings and overall solvency tests that the shareholders whose stock is to be redeemed should become creditors. If the plan of redemption is to pay shareholders over time, those shareholders should have the right to retain shareholder rights for the unpaid shares. A corporation may meet the redemption tests of Chapter 5 at the time the plan of redemption is adopted but not meet those tests at the time of payment to redeemed shareholders. Since the operation of the corporation and its financial accounting may determine whether the redeemed shareholders get paid, those shareholders may want to retain their voting and inspection rights as shareholders.

SAN DIEGO COUNTY BAR ASSOCIATION

Since Section 402 of the Code expressly provides that shareholders whose preferred shares are redeemed by the corporation do not become creditors unless the purchase or redemption is permitted under Chap. 5, existing law is already sufficiently clear.