Cal. Prac. Guide Corps. Ch. 1-A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 1. Preliminary Considerations

A. Lawyer's Role

1. [1:1] Need for Counsel in Organizing New Business
2. [1:2] Counsel's Functions
3. [1:3] Competence to Handle Matter
    a. [1:3.2] Handling matters beyond own expertise
        (1) [1:4] General duty to refer, associate or consult with specialist
        (2) [1:4.1] Exception—"emergency" advice
        (3) [1:5] Application to advising clients forming new business
    b. [1:7.1] "Good faith" as excuse
        (1) [1:7.2] What constitutes "good faith"
        (2) [1:7.3] Mere negligence
4. [1:7.4] Diligence in Handling Matter
5. [1:8] Ethical (Conflict of Interest) Limitations on Representation
    a. [1:9] Representing multiple clients/adverse interests
        (1) [1:9.4] Disclosure and written consents required
            (a) [1:9.5] "Joint client waiver" of attorney-client privilege
            (b) [1:9.5a] Consequential waiver of individual confidences
            (c) [1:9.5b] Compare—implied consent
                1) [1:9.5c] *Caveat*
            (d) [1:9.6] *Caveat*—conflicting professional obligations precluding "informed written consent"
            (e) [1:9.6a] Consent to future conflicts ("blanket advance waivers")
                1) [1:9.6b] Comment
            (f) [1:9.6f] Impact of conflict on attorney fees entitlement
            (g) [1:9.6g] Other potential consequences of noncompliance
        (2) [1:9.7] Concurrent representation of conflicting interests
            (a) [1:9.8] Attorney-client relationship not a prerequisite
            (b) [1:10] Representation of conflicting interests in *same* matter ("dual representation")
                1) [1:11] "Potential" conflict
                2) [1:11a] Includes prospective clients
                    a) [1:11b] Conflict extends to attorney's firm
                    b) [1:11c] Limitations
                    c) [1:11d] Prospective vs. actual client
                3) [1:11g] Representation to memorialize parties' prior agreement
                4) [1:11.1] Where potential conflicts ripen into actual conflicts

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [1:11.1a] Client's advance consent to representation of other joint client
b) [1:11.1b] Comment
5) [1:11.1e] Representation of "deadlocked" corporation—consent of all directors required
6) [1:11.2] No "dual representation" of conflicting interests in litigation matters
a) [1:11.2a] Joint representation of corporation and shareholder in suit brought by other shareholder
b) [1:11.2f] Compare—potential conflict
c) [1:11.3] Compare—no per se conflict in representing entities and its owners/ managers in their official capacity
(c) [1:11.4] Representation of conflicting interests in *separate* matters
1) [1:11.4a] Disqualification absent client consent
2) [1:11.5] Withdrawal from "less favored" representation not an alternative
3) [1:11.5a] Compare—representing business organizations (conflict between principal and other client)
a) [1:11.5b] Relevant factors
b) [1:11.5c] Attorney's duty of loyalty assessed
4) [1:11.5g] Compare—potential conflict arising from parent/subsidiary relationship
a) [1:11.5h] Exception—"single entity" status
(3) [1:11.6] Successive representation of conflicting interests
(a) [1:11.6a] Conflict where attorney's former *firm* represented client
(b) [1:11.6b] No use of confidential information to former client's disadvantage
(c) [1:11.7] Representing clients with interests adverse to former clients; "substantial relationship" test
1) [1:11.7a] Attorney's knowledge of client confidential information presumed
2) [1:11.7b] Presumption not rebuttable where counsel switches sides in same matter
3) [1:11.7c] Knowledge of former client's "playbook"
a) [1:11.7d] Former general counsel representation distinguished
4) [1:11.7e] Conflict arising from prior joint representation
5) [1:11.7f] "Former clients" may include "prospective" clients
6) [1:11.7g] Application where former attorney retained as adverse party's expert witness
7) [1:11.7h] Compare—potential liability where attorney's personal activities adversely affect former client
(d) [1:11.7i] Potential conflict arising from parent/subsidiary relationship
1) [1:11.7j] Single entity determination
a) [1:11.7k] Alter ego test
b) [1:11.7*l*] "Unity of interest" test
(e) [1:11.7p] Compare—attorney's representation of corporate insiders in derivative action despite prior representation of corporation
(4) [1:11.8] Law firm members' representation of conflicting interests ("vicarious disqualification")
(a) [1:11.8a] No vicarious disqualification based on member's personal interest
(b) [1:11.8b] Lawyer's association with prior firm
1) [1:11.8c] Substantial participation
2) [1:11.8d] No vicarious disqualification arising from nonlawyer's participation in client matter
3) [1:11.8e] Effective screening
a) [1:11.8f] Additional measures recommended by case law
(c) [1:11.8g] Ordinarily, no law firm disqualification after conflicted attorney leaves firm
(d) [1:11.8h] Waiver by client
(e) [1:11.8i] Compare—no automatic disqualification of firm hiring lawyer from adverse firm

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(f) [1:11.8j] Compare—no disqualification of firm based on confidential information acquired by associated firm
(g) [1:11.8k] No vicarious disqualification arising from nonlawyer's participation in client matter
(5) [1:11.9] Counsel's (or firm member's) interest in subject matter or relationship with other interested persons
(a) [1:11.9a] Additional considerations
(b) [1:11.10] Application—counsel as former director or employee of adverse party
(6) [1:11.11] No conflict from attorney spouse's relationship with opposing party
(7) [1:11.11d] Standing to seek disqualification ordinarily limited to aggrieved client
(a) [1:11.11e] Exception—nonclient shareholder bringing derivative action
b. [1:11.12] Business dealings with clients
(1) [1:12] Minimum ethical requirements
(a) Application
1) [1:12a] Client loans to counsel
2) [1:12b] Security arrangements for fees
a) [1:12c] Property transfer or secured promissory note
1/ [1:12d] Compare—unsecured promissory note
b) [1:12e] Charging liens
c) [1:12f] Distinguish—“retaining liens” *invalid*
3) [1:12g] Investing with clients
4) [1:12h] Accepting stock in client for arranging financing
5) [1:12.1] Accepting stock in client for legal services
a) [1:12.2] Rationale
b) [1:12.3] “Reasonableness” to client
1/ [1:12.4] “Reasonable fee” as starting point
2/ [1:12.5] Percentage of stock as payment for fee
c) [1:12.6] Disclosure of transaction's ramifications
d) [1:12.7] Law firm precautionary measures
(b) [1:13] Rule 1.8.1 as measure of fiduciary duty—impact on civil liability exposure
(c) [1:13.1] Attorney's burden of proving fairness
(2) [1:13.5] Competing with former clients
c. [1:14] Serving as director of corporate client
(1) [1:14.1] Suggested precautions
6. [1:16] Limited Practice of Law in California by Out-of-State Counsel

1. [1:1] **Need for Counsel in Organizing New Business:** Most persons recognize their need for legal counsel in organizing a new business. The many decisions required and alternatives available in the formation process are like a series of crossroads leading in different directions: If one wrong turn is taken, the parties likely will end up at a different destination than intended. Therefore, most persons seek legal counsel to assist them in meeting their objectives.

2. [1:2] **Counsel's Functions:** In a sense, the attorney acts as “midwife” in forming a new business entity. The attorney assists in its creation, and then provides the initial guidance necessary for its growth. Specifically, counsel's functions usually include the following:

• Identifying the clients' objectives and concerns;

• Ascertaining all relevant information necessary to advise the clients;

• Analyzing the clients' objectives and the information obtained in light of the applicable legal considerations (i.e., the tax, corporate and securities laws);

• Advising the clients of the various alternatives available to them, and assisting them in arriving at the optimum plan of organization; and

• Implementing whatever plan has been decided upon.

3. [1:3] **Competence to Handle Matter:** An attorney must not "intentionally, recklessly, with gross negligence, or repeatedly fail to perform legal services with competence" (i.e., the attorney must apply the learning and skill, as well as the mental, emotional and physical ability, reasonably necessary for the performance of the service). [CRPC 1.1(a) &(b) (formerly CRPC 3-110(A) & (B)); compare ABA Model Rule 1.1—"[A] lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation"; and see *Stevens v. State Bar* (1990) 51 C3d 283, 290, 272 CR 167, 171—attorney intentionally failed to perform legal services competently by incorporating client's company in purchasers' names before sale completed and without client's knowledge or consent]

The lawyer also has a duty to ensure that *subordinates* act competently. [CRPC 1.1(b) & 5.3]

➪ [1:3.1] ***PRACTICE POINTER:*** Attorneys are notoriously poor judges of their own limitations and often tend to take on more than they can handle. Therefore, be *extremely careful* about entering unfamiliar areas of practice—there is a substantial risk of malpractice liability and professional discipline in such situations.

a. [1:3.2] **Handling matters beyond own expertise:** An attorney who lacks sufficient learning and skill to handle the matter "competently" must either decline the case (or discontinue representation if the lack of expertise becomes apparent after the case is accepted) *or* take one of the following steps:

• *Associate or consult with* another lawyer reasonably believed to be competent; or

• *Acquire sufficient learning and skill* before performance is required; or

• Refer the matter to another lawyer reasonably believed to be competent. [CRPC 1.1(c) (formerly CRPC 3-110(C))]

(1) [1:4] **General duty to refer, associate or consult with specialist:** An attorney who undertakes to represent a client on a matter requiring specialized learning and skill is held to the same standard of competence as a specialist in the field. Thus, attorneys *lacking* the requisite learning and skill are exposed to *malpractice* liability (as well as disciplinary action); i.e., the failure to refer the client to, or associate or consult with, counsel with appropriate expertise in such circumstances itself constitutes professional negligence. [See *Horne v. Peckham* (1979) 97 CA3d 404, 415, 158 CR 714, 720 (overruled on other grounds by *ITT Small Business Finance Corp. v. Niles* (1994) 9 C4th 245, 256, 36 CR2d 552, 559); *and* ¶ *1:35.2* re payment of fees to outside counsel]

(2) [1:4.1] **Exception—"emergency" advice:** Though not possessing the learning and skill ordinarily required, an attorney may give advice or assistance in an *emergency* where referral to or consultation with another lawyer would be "impractical." But such "emergency advice" should be limited to that *reasonably necessary under the circumstances.* [See CRPC 1.1(d) (former CRPC 3-110, Discussion)]

(3) [1:5] **Application to advising clients forming new business:** Increasing complexities in tax and corporate securities laws affecting the organization of a business entity demand increasing competence by lawyers advising business clients. Of course, this does *not* mean every client with a tax or corporate securities problem must be referred to a specialist. Indeed, many such problems are so frequently encountered and the rules so well known that they can be handled by a general practitioner. [See *Horne v. Peckham* (1979) 97 CA3d 404, 415, 158 CR 714, 720]

On the other hand, many tax or corporate securities problems require knowledge and skill beyond the level of competence of most general practitioners. In such cases, a general practitioner who is not an expert may owe a duty to consult with or associate a specialist, or refer the client to such specialist. Failure to do so may lead to malpractice liability or disciplinary charges. [See *Horne v. Peckham*, supra]

➪ [1:6] ***PRACTICE POINTER:*** The important thing is to *recognize* the need for expert assistance when it exists. If you are not an expert in tax or securities law, be candid with the client regarding the need to associate or consult with a specialist. Most business clients will appreciate your candor and the value of having an expert review their problem.

Be sure to confirm in writing whatever understanding is reached with the client and the specialist (if outside your firm). Your engagement letter (*see Form 1:A*) should state the matters upon which outside expertise will be sought and the limits of your own undertakings with respect to such matters. In *addition*, confirm in writing with the experts (with copies to the client) those matters upon which they are assuming responsibility. This will avoid confusion or duplication of efforts, or matters "slipping through the cracks."

➪ [1:7] ***PRACTICE POINTER:*** Even if you refer the matter to a tax or securities law specialist, you should continue to act as liaison with the clients. Your existing relationship with them will usually make it easier to ascertain the facts, gather whatever information the specialist may require, and arrive at decisions that need to be made. Moreover, your doing so tends to ensure that, after the business organization is complete, the clients will expect you to continue to represent them.

b. [1:7.1] **"Good faith" as excuse:** "Good faith" is no defense to malpractice (professional negligence) liability.

However, good faith may be relevant in determining whether the attorney's mistakes warrant suspension, disbarment, or other professional discipline.

(1) [1:7.2] **What constitutes "good faith":** "Good faith" in rendering legal services means more than lack of intent to take advantage of the client or to harm the client's interests. Attorneys are *not* acting in "good faith" if they attempt to perform services they *know or should know* they cannot competently perform without consulting or associating competent counsel. Professional discipline is appropriate under such circumstances. [*Lewis v. State Bar* (1981) 28 C3d 683, 689, 170 CR 634, 637—criminal lawyer undertook to handle probate estate, having no prior knowledge of probate procedures]

(2) [1:7.3] **Mere negligence:** An attorney's "negligent" representation may give rise to malpractice liability. However, an attorney is not subject to professional discipline unless the attorney "intentionally, recklessly, with gross negligence, or repeatedly" fails to perform legal services with competence. Thus, a single act of mere negligence is not sufficient to warrant professional discipline, but *repeated* acts of incompetency may result in discipline … even if each act was merely negligent (i.e., neither intentional, recklessly incompetent nor grossly negligent). [CRPC 1.1(a) (formerly CRPC 3-110(A))]

4. [1:7.4] **Diligence in Handling Matter:** Attorneys must also act with diligence in performing legal services for their clients, and thus must be careful not to take on more work than they can handle. An attorney "shall not intentionally, repeatedly, recklessly or with gross negligence fail to act with reasonable diligence in representing a client." [CRPC 1.3(a) (formerly CRPC 3-110(B))]

"Reasonable diligence" means acting with commitment and dedication to the interests of the client and not neglecting or disregarding, or unduly delaying, a legal matter entrusted to the attorney. [CRPC 1.3(b) (no counterpart under former CRPC)]

5. [1:8] **Ethical (Conflict of Interest) Limitations on Representation:** Situations may arise in which, because of a conflict of interests, an attorney is ethically barred from accepting employment or dealing with the clients in the formation of a business entity.

Cross-refer: The sections below (*¶ 1:9 ff.*) summarize the pertinent California Rules of Professional Conduct (CRPC) dealing with conflicts of interest. For a thorough discussion of the subject, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 4.

a. [1:9] **Representing multiple clients/adverse interests:** Conflicts of interest between an attorney and a *current* or *former* client may arise in a variety of circumstances surrounding the formation of a new business entity:

• [1:9.1] **Concurrent representation of conflicting interests:** An attorney is often called upon to do all the work, in effect representing all sides. Or, while the attorney represents only one party in a particular transaction, the attorney may be simultaneously representing *another* client with adverse interests in an *unrelated* matter. Either situation presents the problem of *concurrent* representation of clients with conflicting interests. [CRPC 1.7(a), (b) (formerly CRPC 3-310(C))]

• [1:9.2] **Successive representation of conflicting interests:** Although the attorney represents only one party, the attorney may have *formerly* represented *another party* whose interests conflict with the current client (*successive* representation of a client adverse to a *former* client). [CRPC 1.9(a) (formerly CRPC 3-310(E))]

• [1:9.3] **Attorney's adverse interest:** The attorney may have an *interest in the subject matter* of the representation or a present or past "legal, business, financial, professional, or personal relationship" with *another party* in the same transaction. [CRPC 1.7(b), (c) (formerly CRPC 3-310(B))]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [1:9.4] **Disclosure and written consents required:** Counsel is not necessarily forbidden from representing a client in any of the above situations (¶ *1:9 ff.*). However, at a minimum, counsel must provide the affected clients with *written disclosure* of the potential conflicts of interest (CRPC 1.7(a)-(c), 1.9(a) (formerly CRPC 3-310(B), (C) & (E))); and, where the conflict arises out of concurrent or successive representation of conflicting interests, representation may ethically proceed only with the affected clients' *informed written consent* (CRPC 1.7(a), (b), 1.9 (a), (b) (formerly CRPC 3-310(C) & (E))).

"Informed written consent" means the affected clients' written agreement to the representation *after* having been informed by counsel of the "relevant circumstances" *and* the "material risks, including any actual and reasonably foreseeable adverse consequences" to the clients. [CRPC 1.0.1(e), (e-1), (n) (formerly CRPC 3-310(A)); see *Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co., Inc.* (2018) 6 C5th 59, 84, 237 CR3d 424, 442—"To be informed, the client's consent to dual representation must be based on disclosure of all material facts the attorney knows and can reveal … An attorney or law firm that knowingly withholds material information about a conflict has not earned the confidence and trust the rule is designed to protect."; *Gilbert v. National Corp. for Housing Partnerships* (1999) 71 CA4th 1240, 1255, 84 CR2d 204, 214—"Clearly, as a threshold matter one must know of, understand and acknowledge the presence of a conflict of interest before one can give *informed* consent to its existence" (emphasis in original)]

While the extent of the requisite disclosure will vary in each situation, at a minimum the clients should probably be apprised of the following:

(a) [1:9.5] **"Joint client waiver" of attorney-client privilege:** Under former CRPC 3-310 and case law decided thereunder, "informed consent" required disclosure that joint representation on a matter of common interest will result in each client's waiver of the attorney-client privilege with respect to communications with counsel in the event of subsequent litigation *between themselves* (Ev.C. § 962). [Former CRPC 3-310, Discussion; see *Marriage of Egedi* (2001) 88 CA4th 17, 24, 105 CR2d 518, 523; see also *Fiduciary Trust Int'l of Calif. v. Sup.Ct. (Brown)* (2013) 218 CA4th 465, 482-486, 160 CR3d 216, 228-232—Ev.C. § 962 does not implicitly permit concurrent or successive representation of conflicting interests; compare *Roush v. Seagate Tech., LLC* (2007) 150 CA4th 210, 223-225, 58 CR3d 275, 284-286—co-employees represented by same attorney in *separate* suits against their employer were not "joint clients" despite cooperative sharing of information]

While this requirement does not expressly appear in CRPC 1.7, the waiver of attorney-client privilege may be considered one of the "reasonably foreseeable adverse consequences" requiring disclosure under CRPC 1.0.1(e) (¶ 1:9.4).

(b) [1:9.5a] **Consequential waiver of individual confidences:** As a result of the Ev.C. § 962 "joint client exception" (¶ 1:9.5), multiple clients also *waive any confidences from each other* with respect to the common matter, thus permitting the attorney to serve with equal loyalty and openness toward each. [See *Wortham & Van Liew v. Sup.Ct. (Clubb)* (1987) 188 CA3d 927, 932-933, 233 CR 725, 728-729]

(c) [1:9.5b] **Compare—implied consent:** In extreme circumstances, a client's consent to an attorney's representation of conflicting interests may be implied. "Where a party's course of conduct under all of the circumstances reflects a knowing, informed choice to permit continued concurrent representation [in separate matters] notwithstanding potential or actual adverse interests, we conclude that requiring a writing as the sine qua non of effective consent would celebrate literalism and elevate form over substance to the detriment of substantial justice for the other parties." [*Antelope Valley Groundwater Cases* (2018) 30 CA5th 602, 624, 241 CR3d 692, 709]

1) [1:9.5c] ***Caveat:****Antelope Valley* involved a complicated multi-party litigation matter in which a law firm, which acted as general counsel to a public entity *before* the entity became a party to the litigation, also represented another party whose interests were somewhat adverse to the public entity. The simultaneous representation in separate matters continued for *10 years with the parties' full knowledge and without objection*. Moreover, there was no evidence that confidential information germane to the litigation had ever been disclosed, and a motion to disqualify was brought only after the public entity terminated the law firm as its general counsel. Lastly, the court's finding of implied consent is arguably dictum because the court also found, as an independent ground for its decision, that the disqualification motion was untimely. [See *Antelope Valley Groundwater Cases* (2018) 30 CA5th 602, 614-615, 625-629, 241 CR3d 692, 700, 709-713]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Consequently, a client's implied consent to an attorney's representation of conflicting interests is likely to be found only in extreme circumstances involving sophisticated clients over an extended period of time with no evidence of detriment to the client.

(d) [1:9.6] ***Caveat—conflicting professional obligations precluding "informed written consent":*** Other rules and laws, such as the attorney's duty to preserve client confidences (see Bus. & Prof.C. § 6068(e)), may preclude making adequate disclosure. In such situation, "informed written consent" cannot be obtained; and, consequently, counsel will have to *decline* the proposed "dual" or other adverse interest representation. [See CRPC 1.7, Comment [7] (formerly CRPC 3-310, Discussion); see also *Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co., Inc.* (2018) 6 C5th 59, 86, 237 CR3d 424, 443, fn. 8]

(e) [1:9.6a] **Consent to future conflicts ("blanket advance waivers"):** A client may give informed written consent to future conflicts so long as the client reasonably understands the material risks that an advance waiver entails. The more comprehensive the attorney's explanation of (i) the types of future representations that might arise and (ii) the actual and reasonably foreseeable adverse consequences to the client, then the more likely the client will have the requisite understanding to consent to the future conflicts. The relevant considerations are the client's experience and sophistication, as well as whether the client is independently represented in connection with giving consent. [CRPC 1.7, Comment [9]]

1) [1:9.6b] **Comment:** The California Supreme Court had occasion to address "blanket advance waivers," but concluded that the future conflict waiver at issue was ineffective because the firm failed to disclose a *known, existing* conflict with another client, thus rendering the consent not "informed" (*see ¶ 1:9.4*). Although the Court declined to address the legality of blanket advance waivers, it noted that, when it approved the CRPC that went into effect November 1, 2018, it approved Comment [9] toCRPC 1.7 (¶ 1:9.6a). [*Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co., Inc.* (2018) 6 C5th 59, 85-86, 237 CR3d 424, 443-444, fn. 7]

[1:9.6c - 1:9.6e] ***Reserved.***

(f) [1:9.6f] **Impact of conflict on attorney fees entitlement:** An attorney who violates the ethical rules governing *conflict-free* representation jeopardizes their entitlement to legal fees. Unless counsel obtained the client's informed written consent as required by the CRPC (¶ 1:9.4), counsel may *forfeit* the right to attorney fees (both contractual and quantum meruit) for services rendered during the period of the violation. [See *Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co., Inc.* (2018) 6 C5th 59, 87-96, 237 CR3d 424, 445-452—because firm's ethical breach rendered entire engagement agreement unenforceable, firm not entitled to unpaid contractual fees (whether firm may recover under quantum meruit to be determined by trial court after considering all relevant facts and circumstances); *A.I. Credit Corp., Inc. v. Aguilar & Sebastinelli* (2003) 113 CA4th 1072, 1079, 6 CR3d 813, 819]

(g) [1:9.6g] **Other potential consequences of noncompliance:** Of course, representation of conflicting interests without client consent may also lead to *disciplinary action* and, if the client suffers damages as a result, may support a professional *malpractice*, *breach of fiduciary duty* and/or *breach of contract* cause of action. [CRPC 1.0(b)(1) (formerly CRPC 1-100(A)); see, e.g., *Stanley v. Richmond* (1995) 35 CA4th 1070, 1086-1092, 41 CR2d 768, 776-780 & fn. 7]

(2) [1:9.7] **Concurrent representation of conflicting interests:** Ordinarily, counsel "shall not" represent a client if the representation is *directly adverse* to another client in the *same* or a *separate* matter. Such representation is permitted only where:

• Counsel obtains each client's *informed written consent* (¶ 1:9.4);

• Counsel reasonably believes they will be able to provide *competent and diligent* representation to each client;

• The representation is *not prohibited by law; and*

• The representation does *not* involve the assertion of a claim by one client against another in the *samelitigation* or *other proceeding before a tribunal*. [CRPC 1.7(a), (d)(1)-(3); see former CRPC 3-310(C) & Discussion (4)—such representation permitted with informed written consent]

(a) [1:9.8] **Attorney-client relationship not a prerequisite:** Application of CRPC 1.7 does not require representation of both clients *as an attorney*. A conflict requiring disclosure and client consent may arise where counsel has *any*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

confidential or fiduciary relationship with a "client" whose interests conflict with those of another client. [*American Airlines, Inc. v. Sheppard, Mullin, Richter & Hampton* (2002) 96 CA4th 1017, 1039-1040, 117 CR2d 685, 702—attorney breached duty to former client by acting as expert witness for another client in related lawsuit against former client]

(b) [1:10] **Representation of conflicting interests in *same matter (“dual representation”):*** This limitation on simultaneously representing clients with actually or potentially conflicting interests *in the same matter* applies whenever a lawyer is asked to represent two or more persons entering into a business venture. In such circumstances, each client may have separate objectives and concerns which conflict with the objectives of the others. Typical situations: one client is putting up most of the capital and wants a priority return; or the client "who had the idea" wants control even though others are contributing most of the capital; or one client wants voting control or a "veto" power over certain acts by the others. [See CRPC 1.7, Comments [2]&[4] (formerly CRPC 3-310, Discussion)]

Here, the principal fiduciary value jeopardized by the "dual representation" is the attorney's duty—and each client's legitimate expectation—of *undivided loyalty*. [*People ex rel. Dept. of Corporations v. SpeeDee Oil Change Systems, Inc.* (1999) 20 C4th 1135, 1146-1147, 86 CR2d 816, 824; *Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 284, 36 CR2d 537, 542; see *Metro-Goldwyn-Mayer, Inc. v. Tracinda Corp.* (1995) 36 CA4th 1832, 1840-1845, 43 CR2d 327, 332-335]

1) [1:11] **"Potential" conflict:**CRPC 1.7(a) does not refer to "potential" conflicts. [Compare former CRPC 3-301(C)(1) (requiring informed written consent to simultaneously represent clients whose interests "potentially conflict")]

Comment [4] to CRPC 1.7, however, states that a conflict exists if there is a "significant risk" that an attorney's ability to effectively represent more than one client "will be" materially limited. Counsel should disclose the conflict to the client and obtain informed written consent when there is a "likelihood that a difference in interests exists or will eventuate" and the conflict "will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of each client." [CRPC 1.7(a), Comment [4] ("The mere possibility of subsequent harm does not itself require disclosure and informed written consent"); compare *Havasu Lakeshore Investments, LLC v. Fleming* (2013) 217 CA4th 770, 779, 158 CR3d 311, 319 & fn. 7 (recognizing "that a mere *hypothetical* conflict is insufficient" to compel attorney disqualification under former CRPC 3-310(C)(1) and there must be "*a reasonable likelihood an actual conflict will arise*") (emphasis in original)]

2) [1:11a] **Includes prospective clients:** The bar against representation of conflicting interests applies where an attorney is approached to take on a matter against a party who simply *consulted* but did *not retain* that attorney. One who consults with an attorney to retain the attorney or secure legal service advice from the attorney in the attorney's professional capacity is a prospective client. [CRPC 1.18(a); see *Med-Trans Corp., Inc. v. City of Calif. City* (2007) 156 CA4th 655, 666-667, 68 CR3d 17, 26; *Pound v. DeMera DeMera Cameron* (2005) 135 CA4th 70, 76, 36 CR3d 922, 926; see also *Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 281, 36 CR2d 537, 540]

Ordinarily, the attorney may *not* represent a client whose interests are materially adverse to a prospective client in the *same* or a *substantially related* matter (*see ¶ 1:11.7*) where the prospective client gave the attorney confidential information material to the matter. However, such representation is permitted if:

- Both the affected client and the prospective client give their informed written consent (¶ 1:9.4); *or*

- The attorney took reasonable measures to avoid exposure to more information than was reasonably necessary to determine whether to represent the prospective client, the attorney is timely screened from any participation in the matter (*see ¶ 1:11.8e ff.*) and is apportioned no part of the fee therefrom, *and* written notice (including a general description of the subject matter about which the attorney was consulted and the screening procedures) is promptly given to the prospective client to enable the prospective client to ascertain compliance with these requirements. [CRPC 1.18(c), (d) & Comments [4], [5]; see also ABA Form.Opn. 510 (3/20/24) (discussing "reasonable measures" necessary to avoid imputation of conflicts of interest under ABA Model Rule 1.18)—to avoid exposure to disqualifying information, lawyer must ask prospective client only for minimum information reasonably necessary to make representation determination and warn prospective client not to provide more information than requested]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [1:11b] **Conflict extends to attorney's firm:** If the attorney is prohibited from undertaking representation adverse to a prospective client, no other lawyer in the attorney's firm may knowingly continue or undertake representation in such a matter, except as provided above (¶ 1:11a). [CRPC 1.18(c)]

b) [1:11c] **Limitations:** Not all persons who communicate information to an attorney are treated as prospective clients within the meaning of CRPC 1.18. A person who unilaterally communicates information to an attorney without reasonable expectation that the attorney is willing to discuss the possibility of retaining the person or providing legal advice is *not* a prospective client. Similarly, a person who discloses information to an attorney after the attorney has stated his or her unwillingness or inability to consult with the person, or a person who communicates information to an attorney without a good faith intention of seeking legal advice or representation, is *not* a prospective client. [CRPC 1.18, Comment [2]]

c) [1:11d] **Prospective vs. actual client:** However, once a person consulting an attorney for legal advice *actually secures* that advice, a prima facie relationship of attorney and client is established. The absence of a formal retainer agreement between the attorney and client is of no consequence. [See *People ex rel. Dept. of Corporations. v. SpeeDee Oil Change Systems, Inc.* (1999) 20 C4th 1135, 1148, 86 CR2d 816, 825; *National Grange of the Order of Patrons of Husbandry v. California Guild* (2019) 38 CA5th 706, 716, 250 CR3d 705, 715]

[1:11e - 1:11f] ***Reserved.***

3) [1:11g] **Representation to memorialize parties' prior agreement:** Where two or more prospective clients approach counsel simply to "document" (or "memorialize") an agreement, the material terms of which they have *already agreed to*, the attorney may ethically represent them both in forming the business entity. There is *no actual conflict* where an attorney represents multiple clients (i) for their joint purpose, (ii) to accomplish a common end result and (iii) to implement their joint plan.

Nonetheless, there remains the possibility of a *potential* conflict of interests, strongly suggesting that counsel must comply with the disclosure and informed written consent requirements. [See *Buehler v. Sbardellati* (1995) 34 CA4th 1527, 1540-1541, 41 CR2d 104, 111-112—no *actual* conflict by attorney who simply documented clients' limited partnership agreement (but court disclaimed consideration of possible violation of former CRPC 3-310(C)(1) (now CRPC 1.7(b)), restricting representation of *potentially* conflicting interests); see also *Marriage of Egedi* (2001) 88 CA4th 17, 24-25, 105 CR2d 518, 523-524—with parties' informed written waiver of potential conflict, attorney may act as scrivener of marital settlement agreement, formalizing draft parties had already agreed to]

• [1:11h] **Comment:***Buehler*, supra, was decided under former CRPC 4-101 and 5-102(B). Current CRPC 1.7(a) requires lawyers to inform each client in writing of potential adverse consequences and obtain each client's informed written consent to joint representation. [See CRPC 1.7(a) & 1.0.1(e), (e-1)—"informed written consent" is defined to include written disclosure of reasonably foreseeable adverse consequences]

4) [1:11.1] **Where potential conflicts ripen into actual conflicts:** Should the clients' potentially conflicting interests develop into "actual" adversity, any "dual representation" must *cease*. Counsel cannot continue the representation unless *both* clients give *new* "informed written consents" after full written disclosure of the relevant circumstances and the adverse consequences. [See CRPC 1.7(a), (b) & Comment [2] (formerly CRPC 3-310(C)(2) and Discussion); compare ABA Model Rule 1.7]

In all likelihood, where informed written consents are not obtained, counsel—now in an *actual* conflict of interest situation—will have to bow out, leaving both clients to hire new attorneys. Otherwise, having been privy to confidential information from one client that is material to the other client's cause, counsel's continued representation breaches ethical rules and risks *malpractice* liability. [See CRPC 1.7& Comment [7] (formerly CRPC 3-310(E)), *discussed at*¶ *1:11.6 ff.*; see also *Gilbert v. National Corp. for Housing Partnerships* (1999) 71 CA4th 1240, 1253-1257, 84 CR2d 204, 212-215; *and*¶ 1:11.6 ff.]

a) [1:11.1a] **Client's advance consent to representation of other joint client:** In their initial written consent to joint representation, the parties may agree that, in the event an actual conflict arises, counsel may continue to represent one designated party and the other party *waives* any right to seek counsel's withdrawal on conflict of interest grounds. If a conflict subsequently develops, the attorney need *not* obtain a *new* consent and may continue to represent the designated party despite the other party's objection. [*Zador Corp., N.V. v. Kwan* (1995) 31 CA4th 1285,

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1303, 37 CR2d 754, 765—former joint client in litigation matter agreed not to disqualify attorney "notwithstanding any adversity [between joint clients] that may develop"; see *Fiduciary Trust Int'l of Calif. v. Sup.Ct. (Brown)* (2013) 218 CA4th 465, 486-488, 160 CR3d 216, 232-234 (discussing *Zador's* requirement for client consent to subsequent representation of joint client)]

b) [1:11.1b] **Comment:** The court's opinion in *Zador* is not a blanket approval of advance waivers and counsel should be cautious in relying on them. The facts of *Zador* provided a strong case for recognizing the waiver: the waiver was detailed and counsel was prompt and diligent in raising the actual conflict with the joint client and advising the client to retain separate counsel. The joint client also reaffirmed his consent to the attorney's continued representation of the other client, confirmed the agreement in writing, and obtained separate counsel. [*Zador Corp., N.V. v. Kwan* (1995) 31 CA4th 1285, 1300-1301, 37 CR2d 754, 762-763]

The effectiveness of an advance waiver generally depends on the client's understanding of the material risks, which is a fact-specific inquiry. [See CRPC 1.7, Comment [9]] Comment [9] to CRPC 1.7 discusses factors that should be considered and makes clear that counsel will increase the likelihood of a client having the requisite understanding (and having the advanced waiver enforced) by providing a "more comprehensive" explanation of the conflicts that may arise and the adverse consequences of those conflicts. [CRPC 1.7, Comment [9]]

[1:11.1c - 1:11.1d] ***Reserved.***

5) [1:11.1e] **Representation of "deadlocked" corporation—consent of all directors required:** An attorney who is asked by an officer/director to represent the corporation on a matter over which the board is deadlocked, or otherwise sharply divided, should obtain *each board member's* informed written consent to act as corporate counsel. If that consent cannot be obtained, the attorney must withdraw from representing the corporation: The attorney cannot purport to act as corporate counsel when in fact the attorney is representing one faction of the board against another. [See *In re Davis* (Rev. Dept. 2003) 4 Cal. State Bar Ct.Rptr. 576, 592-594; *also see* ¶ *6:3.8*]

6) [1:11.2] **No "dual representation" of conflicting interests in litigation matters:** When multiple clients have directly conflicting interests in *litigation* matters, joint representation cannot proceed notwithstanding their willingness to give "informed written consent."

Indeed, where the attorney's advocacy for one client would interfere with the duty of advocacy owed the other, the court is likely to find that any purported consent to the dual representation is "neither intelligent nor informed" and *order counsel's recusal*. [See CRPC 1.7, Comment [8] (formerly CRPC 3-310, Discussion); *People ex rel. Dept. of Corporations v. SpeeDee Oil Change Systems, Inc*. (1999) 20 C4th 1135, 1146-1147, 86 CR2d 816, 824-825]

a) [1:11.2a] **Joint representation of corporation and shareholder in suit brought by other shareholder:** In an action by a shareholder alleging *harm to the corporation*, an attorney cannot represent both the corporation and defendant shareholders who are accused of wrongdoing or whose interests are otherwise adverse to the corporation. This is so whether or not the suit is framed as a derivative action. [See *Blue Water Sunset, LLC v. Markowitz* (2011) 192 C4th 477, 488-489, 122 CR3d 641, 648-649—attorney could not represent both LLC and defendant member in derivative action brought by LLC's only other member; *Ontiveros v. Constable* (2016) 245 CA4th 686, 696-699, 199 CR3d 836, 844-846—attorney could not represent both corporation and 60% shareholder in derivative action brought by 40% shareholder; *Gong v. RFG Oil, Inc.* (2008) 166 CA4th 209, 216, 82 CR3d 416, 422—attorney cannot represent both 51% shareholder and corporation in suit by 49% shareholder alleging personal use of corporate funds and other claims showing harm to corporation; *see also* ¶ *6:612;* compare *Shen v. Miller* (2012) 212 CA4th 48, 57-60, 150 CR3d 783, 790-792 (*discussed at* ¶ *6:612.1*)]

Compare: In a *direct* action in which plaintiff shareholder alleges *harm to himself or herself* rather than to the corporation, an attorney may represent both the corporation and a defendant shareholder so long as the attorney does not currently, or did not in the past, represent plaintiff (and so long as an actual conflict does not arise). Plaintiff's status as a shareholder does not compel disqualification per se … because corporate counsel's duty is to the corporation and not to the shareholders individually (CRPC 1.13(a) (formerly CRPC 3-600), ¶ 6:2 ff.). [*Coldren v. Hart, King & Coldren, Inc.* (2015) 239 CA4th 237, 248-251, 190 CR3d 644, 652-654; Cal. State Bar Form.Opn. 1999-153 (*discussed further at* ¶ *1:11.2f*)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[1:11.2b - 1:11.2e] ***Reserved.***

b) [1:11.2f] **Compare—potential conflict:** Where the conflict is simply *potential* (*see ¶ 1:11*), there may be joint representation at a hearing or trial if preceded by *full disclosure* to and *informed written consent* by all the affected clients. [*Klemm v. Sup.Ct. (County of Fresno)* (1977) 75 CA3d 893, 899, 142 CR 509, 512; Cal. State Bar Form.Opn. 1999-153—attorney may represent corporation and one of its two shareholders in suit by second shareholder where first shareholder/CEO/President has authority to retain corporate counsel and gives informed consent in *potential* conflict situation (*discussed further at ¶ 6:3.8*)]

c) [1:11.3] **Compare—no per se conflict in representing entities and its owners/managers in their official capacity:**CRPC 4.2 provides that an attorney representing a party may not communicate with another party whom the attorney knows is represented by counsel unless the attorney first obtains the consent of that party's counsel. Where the other party is a *corporation*, the prohibition on such "ex parte contact" extends to the corporation's officers, directors and "managing agents" (persons with "substantial discretionary authority over decisions that determine organizational policy"). [CRPC 4.2(b)(1), (d)(1) (formerly CRPC 2-100(A), (B)(1)); see CRPC 4.2(b)(2) (formerly CRPC 2-100(B)(2)) for limitations on opposing attorney's communications with corporate *employees, members, agents or other "constituents";* and *San Francisco Unified School Dist. ex rel. Contreras v. First Student, Inc.* (2013) 213 CA4th 1212, 1231, 153 CR3d 583, 599]

For CRPC 4.2 purposes, counsel representing the corporation also represents its officers, directors and managing agents *in their capacity as corporate officials or representatives*; counsel does *not* represent them *personally*. Thus, corporate counsel is not automatically disqualified from representing a corporation in a corporate manager's class action seeking to "recruit" other managers as class members. [*Koo v. Rubio's Restaurants, Inc.* (2003) 109 CA4th 719, 731-733, 135 CR2d 415, 424-425 (suit over unpaid overtime wages)]

[1:11.3a - 1:11.3e] ***Reserved.***

➪ [1:11.3f] ***PRACTICE POINTERS:*** You do *not* necessarily have to refuse employment or withdraw simply because the clients have divergent views. But you must explain carefully to the clients that their divergent objectives may impair your independent judgment and duty of loyalty to each of them. You should also *recommend* that each consult with independent counsel before proceeding further—and the more important the conflict (or potential conflict), the stronger should be your recommendation.

- If, after such explanation and recommendation, the clients ask you to continue to represent them jointly, you may do so *provided* you obtain their *fully informed written consent* (*¶ 1:9.4*). The written consent must contain your *disclosure* of the areas in which you recognize an actual or potential conflict of interest and set forth the clients' acknowledgment that they have been fully advised in the matter.

FORM: See "Potential conflicts of interest" paragraph in Engagement Letter, Form 1:A.

- If, on the other hand, you do *not* undertake to represent more than one principal, be sure to confirm this *in writing*. Send to the "nonclients" a disclaimer of any undertaking to represent or protect their interests in the matter. This step is an important safeguard against potential malpractice exposure based on alleged "reasonable and foreseeable expectations" that you assumed professional responsibilities toward them.

(c) [1:11.4] **Representation of conflicting interests in *separate matters:*** Ordinarily, an attorney may not simultaneously represent two or more clients in separate matters where the clients' interests conflict. Such representation is permitted only where:

- Counsel obtains each client's *informed written consent* (¶ 1:9.4);

- Counsel reasonably believes they will be able to provide *competent and diligent* representation to each client; *and*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The representation is *not prohibited by law*. [CRPC 1.7(a), (d)(1)-(2) & Comments [1], [4]; see former CRPC 3-310(C)(3) & Discussion—representation of conflicting interests in separate matters permitted with informed written consent] This is so even where the simultaneous representations have *nothing* in common. The concern here is with counsel's duty of *loyalty*. The client has a legitimate expectation that the attorney will not assume any relation that would interfere with dedication of the attorney's *entire energies* to the client's interests. [*Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co., Inc.* (2018) 6 C5th 59, 84, 237 CR3d 424, 442—firm could not take on new litigation client whose interests were adverse to existing client in unrelated labor law matter without both clients' informed written consent; *Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 284-291, 36 C2d 537, 542-546—attorney's duty of loyalty precludes alerting prospective client to statute of limitations on claim against existing client; *Gilbert v. National Corp. for Housing Partnerships* (1999) 71 CA4th 1240, 1256, 84 CR2d 204, 214—attorney representing employees who entered into confidential settlement with employer disqualified from representing another employee whose best interest arguably required other employees to testify in breach of their agreement (loyalty conflict "irreconcilable"); *Metro-Goldwyn-Mayer, Inc. v. Tracinda Corp.* (1995) 36 CA4th 1832, 1840-1845, 43 CR2d 327, 332-335—former general counsel could not represent corporate client in "dormant" securities suit while simultaneously representing adverse interests in unrelated major litigation]

1) [1:11.4a] **Disqualification absent client consent:** Matters involving concurrent representation of adverse interests are subject to a *per se* disqualification rule. Unless each affected client gives informed written consent, counsel *must decline* representation on a new matter involving an interest adverse to the current client … even where the simultaneous representations have *nothing* in common. [CRPC 1.7(a) (formerly CRPC 3-310(C)(3)); *Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co., Inc.* (2018) 6 C5th 59, 84-86, 237 CR3d 424, 441-444; *Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 284-285, 36 CR2d 537, 542-543 & fn. 4; *M'Guinness v. Johnson* (2015) 243 CA4th 602, 622-626, 196 CR3d 662, 677-680—law firm that did various ongoing work for corporation could not represent shareholder and corporation as opposing parties in suit involving other shareholders even though subject matter of suit was unrelated to firm's work for corporation; *Metro-Goldwyn-Mayer, Inc. v. Tracinda Corp*. (1995) 36 CA4th 1832, 1838-1839, 1846, 43 CR2d 327, 331, 336—client's waiver of attorney-client privilege in litigation involving successive representation of conflicting interests (¶ 1:11.6) did not waive duty of loyalty where litigation also involved simultaneous representation on separate matters]

2) [1:11.5] **Withdrawal from "less favored" representation not an alternative:** Counsel cannot circumvent the per se disqualification rule by terminating representation of the current client in an attempt to trigger the less severe "substantial relationship" standard applicable to "former" clients (*see ¶ 1:11.7*). The attorney's duty of loyalty precludes unilateral withdrawal from one client in order to gain another. [*Truck Ins. Exchange v. Fireman's Fund Ins. Co.* (1992) 6 CA4th 1050, 1056-1058, 8 CR2d 228, 232; see also *Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 288, 36 CR2d 537, 544-545—"So inviolate is the duty of loyalty to an existing client that not even by withdrawing from the relationship can an attorney evade it"]

3) [1:11.5a] **Compare—representing business organizations (conflict between principal and other client):** The per se disqualification rule does *not* apply when one of the clients is a *business organization* and the conflict arises between a *principal* of that organization and another client. Automatic disqualification in such circumstances would unfairly deprive parties of their chosen counsel. [See *Responsible Citizens v. Sup.Ct. (Askins)* (1993) 16 CA4th 1717, 1731-1732, 20 CR2d 756, 765—attorney representing partnership does not necessarily have attorney-client relationship with *individual partner* (per se disqualification improper)]

a) [1:11.5b] **Relevant factors:** The threshold issue in such cases is whether counsel representing the business *entity* also has an *attorney-client relationship* with the particular *principal* implicated in the conflict of interests.

Where the client is a business entity, the attorney's primary duty runs to the *entity* acting through its duly authorized directors, officers, employees, shareholders or other constituents overseeing the particular engagement (see CRPC 1.13(a) (formerly CRPC 3-600(A) & (D)), ¶ *6:2 ff.*). However, principals in a closely-held entity frequently expect the attorney also to look out for their individual interests—at least to the extent of warning the principals when proposed actions will affect them adversely or advising them to consult separate

counsel. To determine whether an attorney-client relationship may also arise with the *individual principals*, the *totality of the circumstances* must be examined, including:

• the type and size of the organization;

• the nature and scope of the attorney's engagement by the organization;

• the nature and extent of contacts between the attorney and the individual principals; and

• the attorney's access to information relating to the individual principals' interests in the organization. [*Responsible Citizens v. Sup.Ct. (Askins)* (1993) 16 CA4th 1717, 1733, 20 CR2d 756, 766; see *Johnson v. Sup.Ct. (Sheppard, Mullin, Richter & Hampton)* (1995) 38 CA4th 463, 476-479, 45 CR2d 312, 320-322]

b) [1:11.5c] **Attorney's duty of loyalty assessed:** Per se disqualification is unduly harsh where the individual principal has *no reasonable expectation* of the attorney's loyalty in matters *unrelated to the affairs of the business*. Primary attention should be given to whether the circumstances imply an agreement by the attorney *not to accept other representations adverse to the individual principal's personal interests.* [*Responsible Citizens v. Sup.Ct. (Askins)* (1993) 16 CA4th 1717, 1732-1733, 20 CR2d 756, 765-766]

[1:11.5d - 1:11.5f] ***Reserved.***

4) [1:11.5g] **Compare—potential conflict arising from parent/subsidiary relationship:** Where a corporate parent and its subsidiary are truly separate entities, an attorney may represent the parent or subsidiary in one matter while *simultaneously* representing an interest adverse to the other in an *unrelated* matter. In such circumstances, the potential effect upon one corporation of the attorney's "adverse representation" of the other is indirect, and the representation is consistent with the rule that an attorney's duty of loyalty is owed to the *client corporation* (and *not* its shareholder(s); CRPC 1.13(a) (formerly CRPC 3-600), ¶ 6:2 ff.). [*Brooklyn Navy Yard Cogeneration Partners, L.P. v. Sup.Ct. (Parsons Corp.)* (1997) 60 CA4th 248, 254-257, 70 CR2d 419, 423-424; see Cal. State Bar Form.Opn. 1989-113; and *Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft, LLP* (1999) 69 CA4th 223, 240, 81 CR2d 425, 436]

a) [1:11.5h] **Exception—"single entity" status:** In certain circumstances, a parent and its subsidiary may be considered a *single entity* (i.e., the *same client*), and an attorney attempting to represent one corporation and an interest adverse to the other will be disqualified; *see¶ 1:11.7i ff.*

(3) [1:11.6] **Successive representation of conflicting interests:** Absent the former client's informed written consent (¶ 1:9.4), an attorney who formerly represented a client in a matter may not thereafter represent another person in the same or a "*substantially related*" matter (*see ¶ 1:11.7*) in which that person's interests are *materially adverse* to the former client's interests. [CRPC 1.9(a) (emphasis added); compare former CRPC 3-310(E)—counsel may not represent person against former client if former representation provided counsel with confidential information material to new representation]

(a) [1:11.6a] **Conflict where attorney's former *firm represented client:*** Absent the former client's informed written consent (¶ 1:9.4), the attorney may not *knowingly* represent a person in the same or a "*substantially related*" matter (*see ¶ 1:11.7*) in which a *firm* with which the attorney formerly was associated had previously represented a client:

• Whose interests are *materially adverse* to that person, *and*

• About whom the *attorney* had acquired *confidential information material to the matter*. [CRPC 1.9(b) (emphasis added)]

The bar applies notwithstanding the attorney's promise not to disclose confidential information. A client should not be placed in the precarious position of having to rely on its former counsel's self-assumed position as arbiter of his or her own fidelity and what is and is not confidential information. [*American Airlines, Inc. v. Sheppard, Mullin, Richter & Hampton* (2002) 96 CA4th 1017, 1039, 117 CR2d 685, 701]

(b) [1:11.6b] **No use of confidential information to former client's disadvantage:** Counsel's duty to protect client confidences continues even *after* the formal attorney-client relationship ends. Counsel may not use or reveal a former client's confidential information or secrets to the former client's disadvantage. [CRPC 1.9(c) & Comment [1] (formerly

CRPC 3-310(E) and Discussion); see Bus. & Prof.C. § 6068(e)—attorney must "maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client"; *see also*¶ 1:13.5]

(c) [1:11.7] **Representing clients with interests adverse to former clients; "substantial relationship" test:** A typical scenario invoking CRPC 1.9 arises when counsel is asked to represent a client whose interests are adverse to a former client. Counsel must be disqualified where the former client establishes that the attorney acquired confidential information that could be used against the former client in the new case. Where the former client is unable to make this showing (as is commonly the situation), cases decided under former CRPC 3-310(E) developed the "substantial relationship" test to determine whether confidential information may have been imparted to the attorney when representing the former client. Under this test, the focus is on (i) similarities between the two *factual* situations, (ii) similarities between the *legal issues* posed, and (iii) the nature and extent of *counsel's involvement* with the past and proposed new cases. The attorney's possession of information material to the *evaluation, prosecution, settlement or accomplishment* of the past and current cases must be considered in determining their factual and legal similarities. [*City & County of San Francisco v. Cobra Solutions, Inc.* (2006) 38 C4th 839, 847, 43 CR3d 771, 776-777; *Knight v. Ferguson* (2007) 149 CA4th 1207, 1213, 57 CR3d 823, 827; see *Costello v. Buckley* (2016) 245 CA4th 748, 755-756, 199 CR3d 891, 896-897 & fn. 4—substantial relationship test applies only when former client cannot independently establish that attorney acquired confidential information in first matter that could be used in successive matter]

The CRPC adopts the "substantial relationship" concept. [See CRPC 1.9(a) & (b) & Comment [3]—representation prohibited unless former client gives informed written consent where new matter is "substantially related" to matter involved in prior representation]

1) [1:11.7a] **Attorney's knowledge of client confidential information presumed:** If the "substantial relationship" test (¶ 1:11.7) is met, counsel's knowledge of confidential information adverse to the former client is *presumed*. The proposed new employment must be rejected *unless* counsel obtains the adversely affected client's informed written consent *or* demonstrates that no confidential information "material" to the new client's case was in fact obtained. [*City & County of San Francisco v. Cobra Solutions, Inc.* (2006) 38 C4th 839, 847, 43 CR3d 771, 776-777; *Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 283, 36 CR2d 537, 541; see *National Grange of the Order of Patrons of Husbandry v. California Guild* (2019) 38 CA5th 706, 714, 716, 720, 250 CR3d 705, 713, 714, 718]

2) [1:11.7b] **Presumption not rebuttable where counsel switches sides in same matter:** If the lawyer's former and current employment are on opposite sides of the *very same matter* (or the current matter involves work the lawyer performed for the former client), "the nature of the former representation will *always* be such that the exchange of relevant confidences must be presumed." Thus, when the lawyer switches sides in an ongoing dispute, counsel does not have the option of demonstrating that no "material" confidential information was imparted (¶ 1:11.7a); counsel must obtain the former client's consent in order to represent the present client. [*City Nat'l Bank v. Adams* (2002) 96 CA4th 315, 328-330, 117 CR2d 125, 135-138 (emphasis in original)]

3) [1:11.7c] **Knowledge of former client's "playbook":** While representing a former client, the attorney may have acquired "playbook" information—i.e., information concerning the former client's general business practices or litigation philosophy, such as tactics used in negotiating business deals, settlement strategy and philosophy, personality quirks, or "hot buttons" that can be pushed to cause panic or confusion. [*Wu v. O'Gara Coach Co., LLC* (2019) 38 CA5th 1069, 1082-1083, 251 CR3d 573, 583]

However, "playbook" information gleaned from a prior representation does *not* mandate attorney disqualification *unless* it is *material* to the second representation; "that is, it must be found to be directly at issue in, or have some critical importance to, the second representation." [*Wu v. O'Gara Coach Co., LLC*, supra; *Fremont Indemnity Co. v. Fremont Gen. Corp.* (2006) 143 CA4th 50, 65, 49 CR3d 82, 95; see *Jessen v. Hartford Cas. Ins. Co.* (2003) 111 CA4th 698, 713, 3 CR3d 877, 887—disqualifying information for successive representation purposes is "information material to the evaluation, prosecution, settlement or accomplishment of the litigation or transaction"; *Faughn v. Perez* (2006) 145 CA4th 592, 605-609, 51 CR3d 692, 701-705—court refused to infer that attorney's knowledge of "playbook" information was material or would be applied in current case; ABA Model Rule 1.9, Comment [3]]

a) [1:11.7d] **Former general counsel representation distinguished:** On the other hand, where the attorney's prior representation was as in-house or general counsel, knowledge of the client's "playbook" information may

justify disqualification because the attorney essentially knows the client "inside out." [See *Chugach Elec. Ass'n v. United States Dist. Ct. for Dist. of Alaska at Anchorage* (9th Cir. 1966) 370 F2d 441, 443-444 (decided under Alaska ethical rules)—attorney who served as former general counsel for corporation could not act as trustee for bankrupt company suing corporation for antitrust violations that allegedly occurred when attorney was general counsel; *Global Van Lines, Inc. v. Sup.Ct. (V.I.P. Movers, Inc.)* (1983) 144 CA3d 483, 488-489, 192 CR 609, 612-613—attorney employed as corporation's general counsel for 16 years disqualified from representing plaintiff suing corporation for breach of agency contract (court presumed attorney had acquired substantial knowledge of corporation's policies, attitudes and practices re its agency contracts)]

4) [1:11.7e] **Conflict arising from prior joint representation:** The "substantial relationship" test applies where the successive representation arises from the attorney's prior representation of joint clients—i.e., where a potential conflict between concurrent clients whom the attorney represented on the same matter later ripened into an actual conflict and the attorney continues to represent one of the clients. In such a situation, a "substantial relationship" will almost invariably exist between the prior and the current representations. The issue then becomes whether the attorney obtained the *informed consent* of the joint clients to continue representing one against the other (*see*¶ *1:11.1a ff.*). [*Fiduciary Trust Int'l of Calif. v. Sup.Ct. (Brown)* (2013) 218 CA4th 465, 480-481, 487-488, 160 CR3d 216, 227-228, 232-234; *Zador Corp., N.V. v. Kwan* (1995) 31 CA4th 1285, 1294-1295, 37 CR2d 754, 759-760]

5) [1:11.7f] **"Former clients" may include "prospective" clients:***See* ¶ *1:11a ff.*

6) [1:11.7g] **Application where former attorney retained as adverse party's expert witness:** The CRPC 1.9 bar on successive "representation" of conflicting interests is *not* limited to situations where an attorney's role in both matters is that of *legal counsel*. Former counsel may be barred from *testifying as an expert witness* (or otherwise accepting employment) on behalf of an adverse party if the current matter and former representation bear a "substantial relationship" (¶ *1:11.7*) that jeopardizes the former client's confidences. [*Brand v. 20th Century Ins. Co./21st Century Ins. Co.* (2004) 124 CA4th 594, 605-606, 21 CR3d 380, 386-387]

7) [1:11.7h] **Compare—potential liability where attorney's personal activities adversely affect former client:** A lawyer's fiduciary duties to a client continue even after representation of the client ends (¶ *1:11.6*). This principle is not limited to situations where counsel is working for a new client (i.e., successive representation conflict scenarios). Simply stated, attorneys may *not use* an existing *or former* client's confidential information to that client's detriment or otherwise profit therefrom at the client's expense, whether or not confidential information is actually disclosed. Clients injured by such a breach of fiduciary duty may pursue a damages claim against the attorney. [CRPC 1.9(c); *Oasis West Realty, LLC v. Goldman* (2011) 51 C4th 811, 821-823, 826, 124 CR3d 256, 263-265, 267-268 (attorney who once represented client in connection with proposed real estate development project later became involved in campaign to thwart it)]

(d) [1:11.7i] **Potential conflict arising from parent/subsidiary relationship:** An attorney who once *represented* a parent or subsidiary corporation may be disqualified from representing an interest adverse to the other corporation where there is a *substantial relationship* between the two representations (¶ 1:11.7) and circumstances warrant treating the parent and subsidiary as a *single entity*. [*Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft, LLP* (1999) 69 CA4th 223, 234-252, 81 CR2d 425, 432-444]

1) [1:11.7j] **Single entity determination:** Courts disagree on what circumstances will result in treatment of the two corporations as a single client:

a) [1:11.7k] **Alter ego test:** One case holds that a corporation and its subsidiary will be considered the same client for conflict of interests purposes only where the subsidiary is the parent's *alter ego*. In an alter ego relationship, both corporations likely share an expectation of *loyalty* from the attorney and, further, economic losses suffered by one corporation are likely to result in *direct loss* to the other. [*Brooklyn Navy Yard Cogeneration Partners, L.P. v. Sup.Ct. (Parsons Corp.)* (1997) 60 CA4th 248, 257-258, 70 CR2d 419, 424-425]

b) [1:11.7*l*] **"Unity of interest" test:** Other courts hold that the alter ego test, with its frequent emphasis on undercapitalization (¶ *2:53 ff.*) and failure to observe corporate formalities (¶ *2:52*), is designed to protect corporate *creditors* and hence misses the principal focus of attorney conflict-of-interests analysis—i.e., the *practical consequences* to the *corporations* of the attorney's "dual" relationship. "If that relationship may give the attorney a *significant practical advantage* in a case against an affiliate, then the attorney can be disqualified from taking

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

the case." [*Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft, LLP* (1999) 69 CA4th 223, 252, 81 CR2d 425, 443 (emphasis added)]

This "unfair advantage" results where the corporations share a "unity of interest," as determined from all the circumstances, including whether:

- *confidential information* about the parent or subsidiary was shared with the lawyer representing the "client" entity;
- the parent controls the subsidiary's *legal affairs;*
- the parent and subsidiary have *integrated operations* and *share management personnel;* and
- the parent and subsidiary are *potentially adverse* to each other in connection with the subject matter of the lawyer's representation. [*Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft, LLP*, supra, 69 CA4th at 238-252, 81 CR2d at 435-444; *Lennar Mare Island, LLC v. Steadfast Ins. Co.* (ED CA 2015) 105 F.Supp.3d 1100, 1108-1114 (applying *Morrison Knudsen* factors to concurrent representation); and Cal. State Bar Form.Opn. 1989-113; ABA Form.Opn. 95-390]

[1:11.7m - 1:11.7*o*] *Reserved.*

(e) [1:11.7p] **Compare—attorney's representation of corporate insiders in derivative action despite prior representation of corporation:** An attorney who previously represented the corporation may represent corporate insiders named as defendants in a derivative action notwithstanding a substantial relationship between the current and prior representations. In contrast to the ordinary successive representation situation, the attorney's representation of the insiders in a small or closely-held corporation does *not* threaten the attorney's duty of confidentiality to the company because the insiders already are privy to all of the company's confidential information. Disqualification of the attorney would serve no purpose where the insiders could provide the new attorney with the same information their previous attorney had. [*Beachcomber Mgmt. Crystal Cove, LLC v. Sup.Ct. (Salisbury)* (2017) 13 CA5th 1105, 1112, 1119, 220 CR3d 872, 877, 883—"In a small or closely held company, the company's operations and its insiders typically are so intertwined that any distinction between the two is entirely fictional"]

Cross-refer: For a comprehensive discussion of breach of confidence attorney disqualifications under CRPC 1.9, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 4.

(4) [1:11.8] **Law firm members' representation of conflicting interests ("vicarious disqualification"):** For purposes of CRPC 1.7 (concurrent representation of conflicting interests, ¶ *1:9.7 ff.*) and CRPC 1.9 (successive representation of conflicting interests, ¶ *1:11.6 ff.*), *all members of a law firm are treated as a single unit*. Confidential information known (or presumed known) to one member is *presumed shared* among all members of the firm, including lawyers who have only an "of counsel" relationship with the firm. [See CRPC 1.10 (no counterpart in former CRPC); ABA Model Rule 1.10; see also *National Grange of the Order of Patrons of Husbandry v. California Guild* (2019) 38 CA5th 706, 717, 250 CR3d 705, 716—"Attorneys who work together are presumed to talk to one another"]

Thus, where an attorney is disqualified because the attorney formerly represented the adverse party (and thus knew or was presumed to know confidential information), his or her entire *law firm* is disqualified as well. This is so even if the clients are represented by *different* lawyers within the firm. [See *People ex rel. Dept. of Corporations v. SpeeDee Oil Change Systems, Inc.* (1999) 20 C4th 1135, 1153-1156, 86 CR2d 816, 829-831—"of counsel's" consultation and advice with respect to litigation matter disqualified firm from representing adverse party; *Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 283, 36 CR2d 537, 541; see also *City & County of San Francisco v. Cobra Solutions, Inc.* (2006) 38 C4th 839, 853-854, 43 CR3d 771, 782—City Attorney's office disqualified from representing City in civil litigation matter where office head (City Attorney) previously represented adverse party while in private practice]

The same principle applies when a law firm representing one party associates as counsel an independent attorney who had consulted with the opposing party in the same matter—the law firm is vicariously disqualified. [See *Pound v. DeMera DeMera Cameron* (2005) 135 CA4th 70, 76-77, 36 CR3d 922, 926-927 (successive representation conflict of interest from switching sides in same matter)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [1:11.8a] **No vicarious disqualification based on member's personal interest:** Vicarious disqualification does not apply if it is based on the conflicted lawyer's personal interest and does not present a significant risk of materially limiting the representation of the client by the firm's remaining lawyers. [CRPC 1.10(a)(1)]

(b) [1:11.8b] **Lawyer's association with prior firm:** Where counsel represents a party and another lawyer in the firm was previously associated with a firm that now represents an *adverse* party in the *same or substantially related* matter, counsel may continue to represent the party so long as:

- The other lawyer did not *"substantially participate*" (¶ 1:11.8c) in the matter while at the previous firm;
- The other lawyer is timely *screened* (¶ *1:11.8e ff.*) from any participation in the matter and is apportioned no part of the fee therefrom (but the lawyer may receive a salary or partnership share established by prior agreement); *and*
- The former client (i.e., the previous firm's current client) is promptly given written notice describing the screening and agrees to respond promptly to any written inquiries or objections by the former client about the screening procedures. [CRPC 1.10(a)(2) & Comment [3] (no counterpart in former CRPC)]

1) [1:11.8c] **Substantial participation:** In determining whether a lawyer "substantially participated" in the matter, a number of factors should be considered, such as:

- The lawyer's level of responsibility in the prior matter;
- The duration of the lawyer's participation;
- The extent to which the lawyer advised or had personal contact with the former client; and
- The extent to which the lawyer was exposed to the prior client's confidential information likely to be material in the current matter. [CRPC 1.10, Comment [1]]

2) [1:11.8d] **No vicarious disqualification arising from nonlawyer's participation in client matter:** *See* ¶ *1:11.8k*.

3) [1:11.8e] **Effective screening:** The purpose of screening is to assure the client (or former client) that any confidential information known to the lawyer is neither disclosed to other law firm personnel nor used to the client's detriment. To that end:

- The lawyer must be isolated from any participation in the matter and denied access to files and other materials regarding the matter;
- The firm must institute procedures to ensure that the lawyer does not divulge confidential client information and to protect against other law firm lawyers and nonlawyer personnel from communicating with the isolated lawyer with respect to the matter; and
- The isolated lawyer "shall acknowledge" the obligation not to communicate with others regarding the client matter. [CRPC 1.0.1(k)& Comment [5]]

a) [1:11.8f] **Additional measures recommended by case law:** Other typical elements of ethical screening include:

- Isolation of the conflicted attorney through *physical, geographic and departmental separation* from attorneys and law firm employees working on the case (noting that the bigger the law firm, the more easily the attorney can be isolated);
- Rules and procedures preventing access to confidential information and files, which may include storing physical files in a separate location and encoding electronic documents with access restrictions;
- Giving the attorney no financial incentive with respect to the representation; and
- Disallowing the conflicted attorney supervisory powers over the attorneys involved in the representation, and vice-versa. [*Fluidmaster, Inc. v. Fireman's Fund Ins. Co.* (2018) 25 CA5th 545, 553-554, 235 CR3d 889, 894-895;

Kirk v. First American Title Ins. Co. (2010) 183 CA4th 776, 810-813, 108 CR3d 620, 646-648; see *In re Charlisse C.* (2008) 45 C4th 145, 164-165, 84 CR3d 597, 611-612; and *National Grange of the Order of Patrons of Husbandry v. California Guild* (2019) 38 CA5th 706, 715, 720-721, 250 CR3d 705, 714, 718-719; see also California Lawyers Ass'n Form.Opn. 2021-1 (discussing elements of effective ethical screens)]

(c) [1:11.8g] **Ordinarily, no law firm disqualification after conflicted attorney leaves firm:** Following a lawyer's departure from the firm, the firm is not prohibited from representing a client with interests materially adverse to those of another client represented by the formerly associated lawyer and not currently represented by the firm, *unless*:

• The matter is the *same* or *substantially related* (*see* ¶ *1:11.7*) to that in which the formerly associated lawyer represented the client; *and*

• Any attorney remaining in the firm has *confidential client information material to the matter*. [CRPC 1.10(b); see *Fluidmaster, Inc. v. Fireman's Fund Ins. Co.* (2018) 25 CA5th 545, 550-555, 235 CR3d 889, 892-896; *California Self-Insurers' Security Fund v. Sup.Ct. (Activcare Living)* (2018) 19 CA5th 1065, 1077-1079, 228 CR3d 546, 555-556; *Kirk v. First American Title Ins. Co.* (2010) 183 CA4th 776, 810-813, 108 CR3d 620, 646-648]

(d) [1:11.8h] **Waiver by client:** By giving an informed written consent (¶ 1:9.4), the client may waive the conflict or screening. [CRPC 1.10(c)]

(e) [1:11.8i] **Compare—no automatic disqualification of firm hiring lawyer from adverse firm:** Where a member of a firm representing one party switches to a firm representing an adverse party, courts employ a *modified version* of the "substantial relationship" test (¶ *1:11.7*) to determine whether to disqualify the attorney's current firm. The critical issue is whether confidential information was "reasonably likely" to have been imparted to the conflicted attorney while at the former firm. Vicarious disqualification is not warranted where the attorney *affirmatively shows* they had no exposure to confidential information relevant to the current matter while at the former firm. [*Ochoa v. Fordel, Inc.* (2007) 146 CA4th 898, 907-908, 53 CR3d 277, 284-285; *Adams v. Aerojet-General Corp.* (2001) 86 CA4th 1324, 1340-1341, 104 CR2d 116, 127; see CRPC 1.9(b)]

(f) [1:11.8j] **Compare—no disqualification of firm based on confidential information acquired by associated firm:** The rule imputing confidential information among law firm *members* (¶ *1:11.8*) does not impute confidential information between *separate firms* representing the same party. [See *Frazier v. Sup.Ct. (Ames)* (2002) 97 CA4th 23, 31-32, 118 CR2d 129, 135-136 (involving firm acting as insured's "*Cumis* counsel" and another firm representing insurer)]

(g) [1:11.8k] **No vicarious disqualification arising from nonlawyer's participation in client matter:** A firm or any of its lawyers may represent a client notwithstanding a paralegal's, secretary's or other nonlawyer's involvement in a current or prior matter adverse to the client. However, such a person "ordinarily must be screened from any personal participation in the matter." [CRPC 1.10, Comment [2]; *see* ¶ *1:11.8e ff.*]

(5) [1:11.9] **Counsel's (or firm member's) interest in subject matter or relationship with other interested persons:** A CRPC 1.7 conflict of interest requiring informed client consent (¶ 1:9.4) may also arise where there is a *significant risk* that representation of a client will be *materially limited* by the attorney's responsibilities to or relationship with *another client*, a *former client or third person*, or by the attorney's *own interests*. (If direct adversity subsequently develops between clients, further informed written consent will be required under CRPC 1.7(a) (concurrent representation of conflicting interests, ¶ 1:9.7 ff.).) [CRPC 1.7(b) & Comments [2] & [4]; see *Stanley v. Richmond* (1995) 35 CA4th 1070, 1086-1092, 41 CR2d 768, 776-680—attorney may breach duty of loyalty by representing one party while negotiating to form law partnership with adverse party's lawyer]

Additionally, a conflict of interest requiring written disclosure—*but not requiring consent*—arises where the *attorney* has, or knows that *another lawyer in his or her firm* has, a legal, business, financial, professional or personal relationship with, or responsibility to, another *party* or *witness* in the same matter. This is so even where there is *not* a significant risk that the relationship will materially limit the representation; however, if the particular circumstances present such a risk, informed written *consent* is *required*. [CRPC 1.7(c)(1) & Comment [5] (formerly CRPC 3-310(B) & Discussion, but CRPC 3-310(B) applied to both current and *past* relationships); see *Sharp v. Next Entertainment, Inc.* (2008) 163 CA4th 410, 429-431, 78 CR3d 37, 52-53]

(a) [1:11.9a] **Additional considerations:** In addition to informed consent or disclosure (as the case may be), representation is permitted under either of the foregoing scenarios only if:

• The attorney reasonably believes that they will be able to provide *competent and diligent* representation;

• The representation is *not prohibited by law*; *and*

• The representation will not involve the assertion of a *claim* by one client against another client represented in the *same litigation* or other proceeding before a *tribunal*. [CRPC 1.7(d)]

(b) [1:11.10] **Application—counsel as former director or employee of adverse party:** A past or present relationship producing a conflict of interest frequently arises where the attorney acts or acted as a trustee, director or high-level employee of a corporation or other entity. Like a client, the entity has a right to expect the director, employee or trustee not to breach present or past fiduciary duties and, in particular, not to reveal information acquired in confidence during the relationship. Absent consent from the entity, the attorney *and his or her firm* are *disqualified* from representing a party adverse to the entity.

• [1:11.10a] Thus, a firm was disqualified from representing former employees in litigation against the company that employed them where the firm's principal member had served as the company's chief executive officer shortly before being admitted to the bar. Although he was not an attorney when CEO, he nevertheless received confidential information germane to the litigation. There was no evidence that the firm screened him from the matter and hence it failed to rebut the presumption that confidential information was exchanged. [*O'Gara Coach Co., LLC v. Ra* (2019) 30 CA5th 1115, 1128-1132, 242 CR3d 239, 248-252; compare *Wu v. O'Gara Coach Co., LLC* (2019) 38 CA5th 1069, 1083-1084, 251 CR3d 573, 584—disqualification not appropriate where no showing that principal member of firm representing plaintiff had received confidential information germane to current employment discrimination litigation during member's prior tenure as defendant company's chief executive officer (*discussed further at ¶ 1:11.7c*)]

• [1:11.10b] An attorney's firm was disqualified from representing a party in a contract dispute against a real estate investment trust (REIT) where the attorney had served as a director of the REIT during the contract negotiations. The attorney-director was irrebuttably presumed to have received from the REIT confidential information relevant to the dispute. [*In re Mortgage & Realty Trust* (BC CD CA 1996) 195 BR 740, 751-756]

• [1:11.10c] Similarly, an attorney's position as director of a bank acting as trustee-owner of a corporate litigant prevented the attorney's firm from simultaneously representing a party adverse to the corporation. [*William H. Raley Co., Inc. v. Sup.Ct. (Carroll)* (1983) 149 CA3d 1042, 1047, 197 CR 232, 236]

• [1:11.10d] And an attorney's "position of trust and confidence" with a company, although outside the attorney-client relationship, prevented the attorney and his firm from representing an adverse party in a litigation matter. [*Allen v. Academic Games Leagues of America, Inc.* (CD CA 1993) 831 F.Supp. 785, 788-789]

(6) [1:11.11] **No conflict from attorney spouse's relationship with opposing party:** A disqualifying conflict of interest does not arise from a prior confidential relationship between the attorney's *spouse*, who is also an attorney, and an opposing party. A marital (or similar) relationship between attorneys does not itself give rise to a CRPC 1.7 conflict of interest (successive representation of conflicting interests). [See *DCH Health Services Corp. v. Waite* (2002) 95 CA4th 829, 833-834, 115 CR2d 847, 850-851—avoiding "appearance of impropriety" not a proper basis for ordering attorney disqualification under California rules; also see *Derivi Const. & Architecture, Inc. v. Wong* (2004) 118 CA4th 1268, 1275-1276, 14 CR3d 329, 335]

[1:11.11a - 1:11.11c] ***Reserved.***

(7) [1:11.11d] **Standing to seek disqualification ordinarily limited to aggrieved client:** A party moving to disqualify counsel on conflict of interest grounds must show a legally cognizable interest that is or would be harmed by the attorney's conflict of interest. This generally means that a party seeking disqualification must *have or have had* an *attorney-client relationship* with the "target" attorney. [*Marriage of Murchison* (2016) 245 CA4th 847, 851-852, 199 CR3d 800, 803-804; *Coldren v. Hart, King & Coldren, Inc*. (2015) 239 CA4th 237, 245, 190 CR3d 644, 649—plaintiff 50% shareholder lacked standing to disqualify counsel who allegedly had conflict of interest in jointly representing defendant corporation and other 50% shareholder where counsel never represented plaintiff (*discussed further at ¶ 1:11.2a*); *Great Lakes Const., Inc. v. Burman* (2010) 186 CA4th 1347, 1356-1359, 114 CR3d 301, 307-310—litigant lacked standing to disqualify opposing counsel from jointly representing its adversaries who allegedly had conflict of interest; compare *Jarvis v. Jarvis* (2019) 33

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

CA5th 113, 132, 244 CR3d 722, 734—party seeking disqualification of counsel need not show attorney-client relationship where disqualification is based on counsel's lack of authority to act on behalf of organizational client (partnership)]

(a) [1:11.11e] **Exception—nonclient shareholder bringing derivative action:** A shareholder who brings a derivative action on behalf of the corporation against corporate insiders (officers, directors, employees or other shareholders) has standing to bring a motion to disqualify an attorney on conflict of interest grounds where the attorney represents both the corporation and the insiders. This is so even though the plaintiff shareholder never had an attorney-client or confidential relationship with the attorney.

In the derivative action context, the *corporation's* standing to bring a disqualification motion must, as a policy matter, be *imputed* to the plaintiff shareholder (who may also *waive* any conflict the attorney has in representing both the corporation and the insiders). "Any other rule would run the risk of rendering an organization defenseless when it is most vulnerable, i.e., when it is represented by an attorney who has a conflict because he also represents and is beholden to a company insider who injured the company." [*Blue Water Sunset, LLC v. Markowitz* (2011) 192 CA4th 477, 485-486, 122 CR3d 641, 645-646 (involving limited liability companies, but same principles apply to corporations); see *Ontiveros v. Constable* (2016) 245 CA4th 686, 698, 199 CR3d 836, 845-846; *and* ¶ *6:612 ff.*]

b. [1:11.12] **Business dealings with clients:** The ethical rules also restrict an attorney's ability to engage in business dealings which may have an adverse effect upon *present or former* clients.

(1) [1:12] **Minimum ethical requirements:** Counsel are not absolutely barred from entering into business transactions with their clients (or former clients). But "[a]ttorneys wear different hats when they perform legal services on behalf of their clients and when they conduct business with them." [*Mayhew v. Benninghoff* (1997) 53 CA4th 1365, 1369, 62 CR2d 27, 29]

Any attorney-client business transaction, or other transaction in which counsel might acquire a *pecuniary interest adverse to the client*, is ethically permissible only if these *minimum requirements* are adhered to:

- The transaction and its terms are *fair and reasonable* to the client, and the terms and the lawyer's role in the transaction are *fully disclosed in writing* in a manner that can reasonably be understood by the client; *and*

- The client is either represented in the transaction by an *independent lawyer* of the client's choice, or is advised in writing that the client may seek independent legal advice regarding the transaction and is given *reasonable opportunity* to obtain that advice; *and*

- The client gives *informed written consent* to the terms of the transaction and the lawyer's role in it. [CRPC 1.8.1 (formerly CRPC 3-300); see *Fair v. Bakhtiari* (2011) 195 CA4th 1135, 1169, 125 CR3d 765, 792—attorney who entered into successful business transactions with client without complying with former CRPC 3-300 (now CRPC 1.8.1) could not recover in quantum meruit; *BGJ Assocs., LLC v. Wilson* (2003) 113 CA4th 1217, 1226, 7 CR3d 140, 146—client's receipt of advice from independent counsel does not obviate attorney's need to comply with other requirements of former CRPC 3-300 (now CRPC 1.8.1)]

(a) Application

1) [1:12a] **Client loans to counsel:** Attorneys face disciplinary action when they *accept loans* from their clients without first complying with the disclosure/independent counsel/client consent requirements of CRPC 1.8.1 (formerly CRPC 3-300). [See, e.g., *Sugarman v. State Bar* (1990) 51 C3d 609, 616-617, 274 CR 246, 250—attorney disciplined by 1-year suspension for accepting loan from corporate client's principal in lieu of attorney fees without giving client opportunity to consult independent counsel; *McKnight v. State Bar* (1991) 53 C3d 1025, 1034, 281 CR 766, 770-771—attorney disciplined by 5-year suspension for (among other things) accepting "blank check" personal loan from corporate dissolution client without complying with Rule 3-300 prerequisites]

Compliance is required even where the attorney is not currently performing work for the client. An inactive client is not a "former" client so long as the influence of an attorney-client relationship continues. [*In re Peavey* (Rev.Dept. 2002) 4 Cal. State Bar Ct.Rptr. 483, 489; see CRPC 1.8.1, Comment [4]]

2) [1:12b] **Security arrangements for fees:**Rule 1.8.1 does not limit counsel's right to enter into an attorney fee agreement under which the client retains counsel on a particular legal matter in return for a promise to pay stipulated fees. [See CRPC 1.8.1, Comment [5] (formerly CRPC 3-300, Discussion)]

However, the result is otherwise where the client proposes to give counsel *an interest in the client's property* in order to *secure* the client's attorney fee obligation:

a) [1:12c] **Property transfer or secured promissory note:** An attorney may wish to secure the client's attorney fee obligation by taking the client's *promissory note secured by a deed of trust or lien* on the client's property or by obtaining an *outright transfer* of the client's property. Any security arrangement that gives counsel a *possessory interest* in the client's property, with the power to *summarily* sell, encumber or transfer the property *without judicial review* (e.g., in a nonjudicial foreclosure proceeding, Civ.C. § 2924 et seq.), is clearly an *interest adverse* to the client, triggering the CRPC 1.8.1 ethical obligations. [*Brockway v. State Bar* (1991) 53 C3d 51, 64-65, 278 CR 836, 843-844—client security given in form of quitclaim deed (particularly egregious because property worth more than agreed-upon fees); *Hawk v. State Bar* (1988) 45 C3d 589, 601, 247 CR 599, 606—promissory note for attorney's fee secured by deed of trust on client's real property; *Read v. State Bar* (1991) 53 C3d 394, 411, 279 CR 818, 823-824; see *In re Van Sickle* (Rev.Dept. 2006) 4 Cal. State Bar Ct.Rptr. 980, 991—fee agreement granted lien on client's home to secure attorney fees]

1/ [1:12d] **Compare—unsecured promissory note:** On the other hand, a client's *unsecured* promissory note in payment of fees is not an "adverse interest" within the meaning of CRPC 1.8.1. Hence, counsel may ethically accept (and enforce) the note without complying with CRPC 1.8.1. [*Hawk v. State Bar* (1988) 45 C3d 589, 600-601, 247 CR 599, 605-606; *Law Offices of Dixon R. Howell v. Valley* (2005) 129 CA4th 1076, 1104, 29 CR3d 499, 520]

b) [1:12e] **Charging liens:** Similarly, in litigation matters, an attorney who secures the payment of *hourly* fees by acquiring a charging lien against the proceeds of the client's recovery acquires an *interest adverse to the client;* the lien agreement is unenforceable absent compliance with CRPC 1.8.1. [*Fletcher v. Davis* (2004) 33 C4th 61, 71-72, 14 CR3d 58, 65-66]

However, Rule 1.8.1 does *not* apply to a charging lien given to secure payment of a *contingency* fee. [CRPC 1.8.1, Comment [1]; see *Plummer v. Day/Eisenberg, LLP* (2010) 184 CA4th 38, 49-50, 108 CR3d 455, 463-464]

c) [1:12f] **Distinguish—"retaining liens"** ***invalid:*** In contrast to security interests in client property, "retaining liens" are unenforceable in California as violative of public policy. Thus, attorneys cannot contract for the right to retain the client's papers, deeds, reports or other documents until paid for services rendered. [*Academy of Calif. Optometrists, Inc. v. Sup.Ct. (Damir)* (1975) 51 CA3d 999, 124 CR 668; *Hulland v. State Bar* (1972) 8 C3d 440, 105 CR 152; and see CRPC 1.16(e)(1) (formerly CRPC 3-700(D)(1))]

3) [1:12g] **Investing with clients:** The CRPC 1.8.1 ethical obligations are clearly triggered where counsel considers contributing *money or legal services* in return for a share in a client's *business venture*. [*Fair v. Bakhtiari* (2011) 195 CA4th 1135, 1151, 125 CR3d 765, 777; *BGJ Assocs., LLC v. Wilson* (2003) 113 CA4th 1217, 1226, 7 CR3d 140, 146-147]

However, Rule 1.8.1 is not intended to apply where attorney and client each make *parallel independent investments* on terms offered to the general public (e.g., attorney and client invest in a limited partnership syndicated by a third party). Here, the attorney has not entered into a transaction "with" the client for Rule 1.8.1 purposes. [See CRPC 1.8.1, Comment [6] (formerly CRPC 3-300, Discussion)]

4) [1:12h] **Accepting stock in client for arranging financing:** A transaction whereby counsel will receive the client corporation's stock in return for arranging a loan (or other financing) is likewise subject to the CRPC 1.8.1 requirements. [*Passante v. McWilliam* (1997) 53 CA4th 1240, 1247-1248, 62 CR2d 298, 302 (dictum)]

5) [1:12.1] **Accepting stock in client for legal services:** The American Bar Association's Standing Committee on Ethics and Professional Responsibility has concluded that a lawyer may ethically accept stock in a corporate client in return for legal services rendered to or on behalf of the client so long as the transaction complies with ABA Model Rule 1.8(a), which is almost identical to CRPC 1.8.1 (¶ 1:12). [ABA Form.Opn. 00-418; see also ABA Form.Opn. 11-458 (change in existing fee arrangement that involves lawyer acquiring an interest in client's business ordinarily also requires compliance with ABA Model Rule 1.8(a))]

a) [1:12.2] **Rationale:** A lawyer's representation of a corporation in which the lawyer owns stock creates no inherent conflict between the attorney and corporate management … because both desire to increase the value of the corporation's stock. From the client's standpoint, the lawyer's willingness to invest in a start-up enterprise is

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

frequently viewed as a vote of confidence in the enterprise's prospects and, moreover, may be the only way for a cash-poor client to obtain competent legal services. [ABA Form.Opn. 00-418]

b) [1:12.3] **"Reasonableness" to client:** In assessing whether the transaction is fair and reasonable to the client (*¶ 1:12*), only the circumstances reasonably ascertainable *at the time of the transaction* should be considered. Thus, the risk of the corporation's *failure* and the stock's *nonmarketability* should be taken into account in determining whether the market value of the stock, at the time of the transaction, represented reasonable compensation for the attorney's services. (In the event the business prospers, these factors may counter an allegation that the fee was unreasonably high or "unconscionable," *¶ 1:30 ff.*) [ABA Form.Opn. 00-418]

1/ [1:12.4] **"Reasonable fee" as starting point:** One method of ascertaining "reasonableness" is for the lawyer to establish a *reasonable fee* for the services rendered and then accept stock that is worth the fee at the time of the transaction. The stock should, if feasible, be valued at the amount per share that *cash* investors, knowledgeable about the stock's value, have agreed to pay at about the same time. [ABA Form.Opn. 00-418]

2/ [1:12.5] **Percentage of stock as payment for fee:** When the value of the shares is not reasonably ascertainable (e.g., corporation's assets consist only of intellectual property having unknown value), a reasonable fee may be an agreed *percentage* of stock issued or to be issued. The percentage should reflect the value, as perceived by the client and the lawyer at the time of the transaction, that the legal services will *contribute to the enterprise's potential success*. [ABA Form.Opn. 00-418]

c) [1:12.6] **Disclosure of transaction's ramifications:** In the written disclosure of the terms of the transaction (*¶ 1:12*), counsel should explain the potential effects of his or her stock ownership on the client-lawyer relationship, including:

• The extent to which the lawyer's ownership interest may limit the client's *control of the business*; and

• The potential for a *future conflict* between corporate counsel's exercise of independent professional judgment and counsel's desire to protect counsel's ownership interest. The lawyer should explain that in such circumstances, the lawyer may be compelled to either *withdraw altogether* as counsel or recommend the client obtain *other counsel* to advise on the matter regarding which the attorney has a conflict of interest. [ABA Form.Opn. 00-418]

d) [1:12.7] **Law firm precautionary measures:** To minimize client conflicts, some law firms have adopted policies governing the firm's investments in clients. These policies include:

• Limiting the investment to an *insubstantial percentage* of the stock in the corporation;

• Limiting the amount invested in any single client to a *nonmaterial portion of the firm's worth*;

• Requiring that decisions regarding a firm lawyer's potential client conflict be made by someone other than the lawyer with the principal client contact; and

• Transferring *billing* or *supervisory responsibility* to a partner with *no* stock ownership in the client. [ABA Form.Opn. 00-418]

➪ [1:12.8] ***PRACTICE POINTERS:*** Many experienced practitioners decline to accept shares in their clients' businesses; there are several reasons:

• [1:12.9] ***No payment if business fails or plan abandoned*:** Many new businesses fail or simply never get off the ground. As a result, the attorney may have done a lot of work for nothing. The attorney will not be entitled to bill the client at this point (unless the attorney was prudent enough to negotiate in advance for compensation in such event).

• [1:12.10] ***Potential for irreconcilable conflicts:*** The lawyer may be called upon to prepare routine corporate agreements to which the lawyer, as a shareholder, is a *party* with interests adverse to the corporation or other shareholders (e.g., buy-out agreement, voting trust or shareholders agreement; *see Ch. 3*). In such circumstances, withdrawal as corporate counsel may be the only option.

• [1:12.11] ***Potential inability to render opinions to third parties:*** A conflict may arise where the attorney is called upon to render a formal legal opinion to an adverse party in a transaction to which the corporation is a

party (e.g., major financing arrangement). In such circumstances, the adverse party is usually willing to accept the opinion on the assumption that counsel is "independent"—i.e., counsel does not have a material conflict of interest. At the very least, counsel should consider *disclosing* his or her ownership interest prior to rendering the opinion if the ownership interest is material to counsel. [See Report of Corporations Committee of Business Law Section of Cal. State Bar, "Legal Opinions in Business Transactions (Excluding the Remedies Opinion)" (Oct. 2007), p. 38 (including suggested form of disclosure if counsel chooses to disclose the ownership interest); American Bar Ass'n Legal Opinions Committee and Working Group on Legal Opinions Foundation, "Statement of Opinion Practices" (2019) 74 Bus. Law. 807, 811, ¶ 8.3 (if opinion preparers recognize that others in their law firm have "financial interest in, or other relationship with, the client," they should consider whether "it will compromise their professional judgment," even if disclosed)]

• [1:12.12] ***Adverse tax consequences:*** Since the shares received by the attorney are in lieu of fees, they are *taxable income upon receipt*. The attorney is thus obligated to report the shares at their reasonable value (probably what other investors paid in cash), and to come up with the cash to pay the taxes.

• [1:12.13] ***Danger of being caught "in the middle":*** If the other shares (or ownership interests) are evenly divided and the shareholders get into a dispute, the attorney will be caught "in the middle"—forced to vote with one group or the other (a classic no-win situation).

• [1:12.14] ***No malpractice coverage:*** Some malpractice policies *exclude* coverage for a claim by a client in which the attorney has *any* ownership interest, while other policies provide coverage only if the attorney's ownership interest does not exceed a specified maximum.

(b) [1:13] **Rule 1.8.1 as measure of fiduciary duty—impact on civil liability exposure:** A violation of Rule 1.8.1 does not itself give rise to an independent cause of action. However, the Rule *conclusively establishes* an attorney's duty to his or her client in the client's breach of fiduciary duty action against the attorney—i.e., counsel's breach of fiduciary duty may be measured by his or her violation of Rule 1.8.1 and the jury may be instructed accordingly. [*Mirabito v. Liccardo* (1992) 4 CA4th 41, 46-47, 5 CR2d 571, 574—attorney who induced client to make bad investments in violation of former CRPC 3-300 (now CRPC 1.8.1) liable for client's consequential losses on breach of fiduciary duty theory; see also *Fair v. Bakhtiari* (2011) 195 CA4th 1135, 1154, 125 CR3d 765, 778; *David Welch Co. v. Erskine & Tulley* (1988) 203 CA3d 884, 893, 250 CR 339, 343 (disapproved on other grounds by *Lee v. Hanley* (2015) 61 C4th 1225, 1239, 191 CR3d 536, 548), *discussed at*¶ *1:13.5*]

(c) [1:13.1] **Attorney's burden of proving fairness:** Courts closely scrutinize lawyer business transactions with clients: In any attorney-client transaction in which the attorney is charged with obtaining an advantage from or over the client, the advantage is *presumed* to have been obtained *without adequate consideration* and because of *undue influence;* and the transaction, therefore, is *presumptively voidable* by the client. [See *BGJ Assocs., LLC v. Wilson* (2003) 113 CA4th 1217, 1229, 7 CR3d 140, 149 (citing Prob.C. § 16004); *Mayhew v. Benninghoff* (1997) 53 CA4th 1365, 1369, 62 CR2d 27, 29-30]

Accordingly, in a client's suit to void the transaction or in the attorney's suit to enforce an agreement arising from the transaction, the *attorney* bears the burden of proving the client was fully advised and that the dealings were fair and just. [*Beery v. State Bar* (1987) 43 C3d 802, 812, 239 CR 121, 126; *BGJ Assocs., LLC v. Wilson*, supra; *Mayhew v. Benninghoff*, supra—attorney alleging that arbitration provision in representation agreement applied to side business transaction failed to rebut "presumption of voidability"]

➪ [1:13.2] ***PRACTICE POINTER:*** Many experienced lawyers simply *avoid* business dealings with their clients—no matter how potentially lucrative. Whether or not the business is successful, any substantial investment on the lawyer's part usually makes independent judgment impossible, and thus impairs the duties owed to the client.

[1:13.3 - 1:13.4] ***Reserved.***

(2) [1:13.5] **Competing with former clients:** The ethical prohibition against using a former client's confidential information to the client's disadvantage (CRPC 1.9(c), ¶ 1:11.6b) applies to any other proffered employment which might *compete unfavorably* with the *business* of a former client from whom counsel learned confidential information material to the new employment. [*David Welch Co. v. Erskine & Tulley* (1988) 203 CA3d 884, 892, 250 CR 339, 343 (disapproved on other grounds by *Lee v. Hanley* (2015) 61 C4th 1225, 1239, 191 CR3d 536, 548) (decided under former CRPC 3-310)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

For instance, by acquiring a former collection agency client's accounts, attorneys obtained an *economic advantage opposed to the interests* of the former client. Due to their preexisting attorney-client relationship with the collection agency, during which attorneys were in a position to obtain confidential information about the former client's business, the attorneys were ethically bound to *refrain* from acquiring any pecuniary interest involving collection work for the former client's accounts unless they *first notified* the former client *and obtained its written consent.* Attorneys, "who previously had been privy to [former client's] confidential information, in no way informed [former client] that they were preparing proposals designed to *undercut* [former client's] business relationships." [See *David Welch Co. v. Erskine & Tulley*, supra, 203 CA3d at 891-892, 250 CR at 342-343 (emphasis added)—law firm's violation of former Rules 3-300 & 3-310(E) (now CRPC 1.8.1 & 1.9) supported cognizable breach of fiduciary duty owed to former collection agency client (immaterial that attorneys did not personally solicit former client's accounts)]

c. [1:14] **Serving as director of corporate client:** There is no ethical rule against a lawyer serving on the board of directors of a corporate client.

(1) [1:14.1] **Suggested precautions:** If you decide to serve on your client's board, consider taking the following precautions:

• Explain to management and the board (a) your separate responsibilities as legal counsel and director; (b) as legal counsel, you represent only the corporate entity, not its individual officers and directors (CRPC 1.13, ¶ *6:2 ff.*); and (c) conflicts may arise requiring you to recuse yourself as director and recommend retention of independent counsel to represent the corporation in the matter (or to serve as co-counsel with you);

• Remind management and the board that the attorney-client privilege may not protect discussions at board meetings where you are wearing your "director" hat (*see*¶ *6:1.1*) and where other lawyers representing the corporation are not present;

• Recuse yourself from board discussions regarding your (or your law firm's) performance, engagement, payment or discharge as the corporation's lawyer;

• Maintain and assert your independent professional judgment; recommend against any course of action that is illegal or likely to harm the corporation (even when favored by management or other directors);

• As counsel, carry out the board's decisions even if, as a director, you disagree with those decisions (unless implementing the board's wishes would assist in fraudulent or criminal conduct or director self-dealing, or violate ethical rules);

• Decline any representation as counsel when your interests as a director conflict with your responsibilities of competent and diligent representation. [See ABA Form.Opn. 98-410]

➪ [1:15] ***PRACTICE POINTER:*** Many experienced attorneys decline to serve on a corporate client's board. Their concern is that the two roles may conflict: They may find it impossible to exercise the "independent business judgment" required of directors (*see*¶ *6:245*) and to act as legal advisor at the same time. Moreover, as legal advisor, they may be put in the untenable position of being asked to advise the corporation regarding the actions of fellow directors (including themselves). [See ABA Model Rule 1.7, Comment [35]—leaving it to attorney-directors to determine for themselves whether conflict exists]

Also, attorney-directors (and their malpractice carriers) are concerned about the *personal liability* directors may incur for their acts (*see*¶ *6:243 ff.*). (In fact, applications for "professional liability" insurance or renewals thereof customarily elicit detailed information regarding an attorney's activities as director or officer of corporate clients.)

Still another concern is that other directors may give undue deference to opinions expressed by an attorney-director, thus depriving the corporation of the independent judgment of all of its directors.

6. [1:16] **Limited Practice of Law in California by Out-of-State Counsel:** Subject to very limited exceptions, the right to "practice law" in California is reserved to active members of the *California* State Bar. [Bus. & Prof.C. §§ 6125, 6126]

However, there are two exceptions of particular interest to corporate practitioners, authorizing the "practice of law" in California, as specified, by attorneys licensed to practice in another jurisdiction:

• [1:16.1] Under the conditions specified in *CRC 9.46*, out-of-state counsel residing in California and licensed to practice in another jurisdiction may register to provide legal services as *in-house counsel* for a single “qualifying institution” (corporation, partnership or other legal entity with at least 10 full-time employees in California or an attorney employee in California and licensed by the California Bar) without becoming a member of the California State Bar. [See CRC 9.46; State Bar Rules 3.370-3.377]

• [1:16.2] Under the conditions specified in *CRC 9.48*, out-of-state counsel licensed to practice in another jurisdiction and who are temporarily in California on a non-litigation matter may practice law in California for that purpose although not licensed by the California State Bar. [See CRC 9.48]

*Cross-refer:*Rules 9.46 and 9.48, along with other exceptions authorizing out-of-state counsel to practice law in California, are explained in detail in Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 1.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 1-B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 1. Preliminary Considerations

B. Attorney Fees and Costs Arrangements

- 1. Validity of Fee Agreement
    - a. [1:17] Typical fee arrangements
        - (1) [1:20.1] Deposit into client trust account
            - (a) [1:20.1a] Exception for flat fee
            - (b) [1:20.2] Compare—nonrefundable retainer
    - b. [1:22] Amount to be charged
    - c. [1:24] Taking fees in shares of client's business
    - d. Ethical limitations on fees
        - (1) [1:30] "Unconscionable" fees
            - (a) [1:31] Factors relevant to "conscionability" of fee
                - 1) [1:32] Compare—attorney's profit margin irrelevant
            - (b) [1:33] Marketplace measuring rod
        - (2) [1:35] Fee splitting
            - (a) [1:35.1] Not limited to referral fees
            - (b) [1:35.2] Permissible compensation to outside lawyer
            - (c) [1:35.3] Quantum meruit recovery where fee-splitting agreement unenforceable
        - (3) [1:35.5] Security arrangements for fees
- 2. [1:36] Time for Setting Fees
    - a. [1:37] Before accepting employment
    - b. [1:38] After accepting employment
    - c. [1:40.5] Subsequent fee increases
- 3. [1:41] Agreement re Expenses
    - a. [1:43] Advances by client
        - (1) [1:43.1] Deposit in IOLTA account may be required
        - (2) [1:44.1] Compare—"property" held for client
    - b. [1:45] Advances by attorney
- 4. [1:46] Who is Responsible for Fees and Costs?
- 5. [1:50] Written Agreement Required
    - a. [1:50.1] Required contents
    - b. [1:51] Optional arbitration provision
        - (1) [1:51.1] Fees/costs dispute arbitration
            - (a) [1:51.2] Trial de novo right yields to provision for "standard" arbitration
            - (b) [1:51.3] Client waiver of MFAA rights

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [1:52] Legal malpractice (and other disputes) arbitration
(a) [1:52.1] Ambiguity construed against attorney
(b) [1:52.2] Warning to client
(c) [1:52.3] Caution—no arbitration if entire agreement void for illegality
c. [1:53] Execution of agreement; conformed copy to client
d. [1:53.1] Fee agreement voidable for noncompliance
e. [1:53.3] Exceptions
(1) [1:53.4] Comment
6. Billing Requirements
a. [1:53.7] When billed
b. [1:53.8] Billing information
c. [1:53.9] Failure to comply
7. [1:54] Fees Payable in Installments
a. [1:54.1] Effect of client's failure to pay installment
b. [1:54.2] Effect of truth-in-lending laws
8. [1:54.3] Interest Charges
9. [1:54.4] Client's Federal Tax Obligation to Report Fees
10. [1:54.5] Recourse to Client Trust Account for Payment of Fees

1. Validity of Fee Agreement

a. [1:17] **Typical fee arrangements:** The following are the most common arrangements for legal fees in organizing a business entity:

• [1:18] **Flat fee** for specified services—e.g., "$750 to prepare articles of incorporation, bylaws, organizational minutes, and notice to Commissioner of Financial Protection and Innovation re issuance of shares" (see CRPC 1.5(e)).

• [1:19] **Hourly rate** for services rendered (law firms often bill at varying hourly rates depending on the attorney's level of experience; also, different rates for work done by paralegals).

• [1:20] **Advance fee, or retainer fee** in advance, against which hourly billings charged, and with provision for refund of any unbilled balance (e.g., "$1,000 retainer to be applied against billings at rate of $275 per hour").

Compare—"classic retainer": An "advance fee retainer" secures payment of future legal services and is refundable to the extent not earned. This differs from a "classic retainer" or a "true retainer," which is a *nonrefundable* fee paid solely to ensure an attorney's availability for a specified period or specified matter; it is not compensation for legal services performed or to be performed. (A "classic retainer" is permitted only if the client agrees in writing after disclosure that the fee is not refundable.) [See CRPC 1.5(d); *SEC v. Interlink Data Network of Los Angeles, Inc*. (9th Cir. 1996) 77 F3d 1201, 1204-1206; *T & R Foods, Inc. v. Rose* (1996) 47 CA4th Supp. 1, 6-7, 56 CR2d 41, 44; see also *M'Guinness v. Johnson* (2015) 243 CA4th 602, 619, 196 CR3d 662, 674, fn. 5]

(1) [1:20.1] **Deposit into client trust account:** Advance fees that are *refundable* fee prepayments (other than flat fees, ¶ 1:20.1a) are considered "funds received or held for the benefit of clients" and hence must be deposited in the client trust account (¶ *1:43 ff.*) until such time as the fees are *earned and fixed* (i.e., when the work is performed and billed). [See CRPC 1.15(a) & Comment [2] (formerly CRPC 4-100(A)); *T & R Foods, Inc. v. Rose* (1996) 47 CA4th Supp. 1, 7, 56 CR2d 41, 44]

(a) [1:20.1a] **Exception for flat fee:** A flat fee paid in advance for legal services may be deposited into an *operating* account, rather than in a trust account, so long as written disclosure is made that the client (i) has the right to require deposit into the trust account until the fee is earned and (ii) is entitled to a refund of any unearned portion of the fee. If the flat fee exceeds $1,000, the disclosure must include the client's specific *agreement* to deposit the fee in the operating account and must be *signed* by the client. [CRPC 1.15(b) & Comment [3]]

(b) [1:20.2] **Compare—nonrefundable retainer:** By contrast, CRPC 1.15 does *not* apply to a *nonrefundable* "classic retainer" (*see* ¶ *1:20*) since it is earned when paid and thus presently "belongs" to the attorney. [See *Baranowski v. State Bar* (1979) 24 C3d 153, 164, 154 CR 752, 757, fn. 4; *T & R Foods, Inc. v. Rose* (1996) 47 CA4th Supp. 1, 6-7, 56 CR2d 41, 43-44]

➪ [1:21] ***PRACTICE POINTERS:*** The flat fee arrangement is suitable where the services to be rendered are predictable and more or less routine. Otherwise, the hourly rate, with or without a retainer, is usually the preferred basis for billing legal fees in connection with new business ventures.

If an hourly rate is agreed upon, be sure to indicate the billing method (e.g., monthly statements due upon receipt) and encourage the clients to raise any questions they have concerning their bills as soon as they receive them. Finally, be sure to reserve the *right to discontinue work* if your bills are not promptly paid. Otherwise, you may find your bills uncollectible.

b. [1:22] **Amount to be charged:** The amount to be charged for legal services is subject to negotiation with the clients in each case. There is no "standard" or "minimum" fee.

➪ [1:23] ***PRACTICE POINTER:*** In setting fees with clients who are embarking upon a business venture, keep in mind the potential for continuing business. A new business frequently generates further legal work and leads to other new clients (e.g., investors in the new business). Therefore, you may wish to consider reducing the level of fees charged in organizing the business entity.

Cross-refer: For a discussion of factors to consider in setting fees, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 5.

c. [1:24] **Taking fees in shares of client's business:** *See* ¶ *1:12.1 ff.*

[1:25 - 1:29] ***Reserved.***

d. Ethical limitations on fees

Cross-refer: Ethical considerations in setting fees is also treated in greater detail in Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 5.

(1) [1:30] **"Unconscionable" fees:** A lawyer must not charge or collect a fee that is "unconscionable" or "illegal." [CRPC 1.5(a) (formerly CRPC 4-200(A)); compare ABA Model Rule 1.5—"lawyer shall not charge an unreasonable fee"]

(a) [1:31] **Factors relevant to "conscionability" of fee:** The "conscionability" of a legal fee is evaluated with reference to several factors, including, significantly: the amount of the fee in proportion to the value of services performed, the novelty and difficulty of the issues presented, the time, labor and skill required to perform the requisite services, the attorney's experience, reputation and ability, whether the fee is fixed or contingent, and the client's informed consent. [See CRPC 1.5(b)(1)-(13) (formerly CRPC 4-200(B)(1)-(11)); ABA Model Rule 1.5(a); *Shaffer v. Sup.Ct. (Simms)* (1995) 33 CA4th 993, 1000, 39 CR2d 506, 511, fn. 6]

1) [1:32] **Compare—attorney's profit margin irrelevant:** By contrast, "conscionability" of a legal fee *cannot* be measured by the attorney's office overhead or profit margin; indeed, margin of profit is *irrelevant* to the issue. [*Shaffer v. Sup.Ct. (Simms)* (1995) 33 CA4th 993, 1003, 39 CR2d 506, 513]

"Examination of profits would penalize law firms which are able to produce at costs substantially less than their competitors. It would unfairly penalize the efficient and reward the inefficient." [*Shaffer v. Sup.Ct. (Simms)*, supra—hourly rates law firm paid to contract attorney neither relevant nor discoverable in determining conscionability of firm's fees]

(b) [1:33] **Marketplace measuring rod:** In practice, when examining the "conscionability" of a legal fee, courts consider whether the legal services rendered were worth the charged amount *in the marketplace*. If other attorneys in the community with similar experience and ability would have charged fees that are not disproportionally dissimilar to those charged by the attorney in question, it is highly unlikely the fee would be considered "unconscionable." [See *Shaffer v. Sup.Ct. (Simms)* (1995) 33 CA4th 993, 1002, 39 CR2d 506, 512; see also *Bushman v. State Bar* (1974) 11 C3d 558, 563, 113 CR 904, 906—billings "unconscionable" if so excessive as to "shock the conscience" of prudent lawyers in the community]

➪ [1:34] ***PRACTICE POINTER:*** In determining "conscionability" of fees charged for services on business matters, courts (or the State Bar) often focus on the attorney's *expertise*—or lack thereof. This is because experienced practitioners may be able to perform the services in question far more efficiently—thus enabling them to charge lesser fees to the client, promoting goodwill and enhancing public relations.

(2) [1:35] **Fee splitting:** An attorney may divide fees with another lawyer who is not in the same law firm only if:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The attorney and the other lawyer enter into a written agreement to divide the fee;

• The *client consents* in *writing*, either at the time the fee-splitting agreement is entered into or as soon thereafter as reasonably practicable, after full disclosure of the identity of the lawyer and the terms on which the legal fees are to be divided; and

• The total fee is not increased solely by reason of the fee-splitting arrangement. [CRPC 1.5.1 (formerly CRPC 2-200(A)); see *Mink v. Maccabee* (2004) 121 CA4th 835, 838, 17 CR3d 486, 488—client consent may be obtained after attorneys enter into fee-split agreement and perform services so long as obtained before actual "division" of fees (predating CRPC 1.5.1 requirement that consent be obtained at time agreement entered into or as soon thereafter as reasonably practicable)]
Compare: Rule 1.5.1 does not apply to fee-sharing arrangements within the same law firm. Practitioners who share office space and occasionally consult or assist each other would *not* be regarded as a law firm; however, lawyers who present themselves to the public in a way that suggests they are a law firm or conduct themselves as a law firm "may" be regarded as a law firm. [CRPC 1.5.1(a), 1.0.1(c) ("firm or law firm" defined) & Comments [1] & [2]; see *Anderson, McPharlin & Connors v. Yee* (2005) 135 CA4th 129, 132-133, 37 CR3d 627, 630 (law firm partnership agreement requiring withdrawing partner to pay firm specified amount of revenues partner received from firm's clients on open matters)]
(a) [1:35.1] **Not limited to referral fees:** The CRPC 1.5.1 restrictions on fee splitting are not limited to pure referral situations—i.e., where an attorney seeks a percentage of the fees for merely referring a matter to another lawyer who performs all the work. Rule 1.5.1 also applies where the referring attorney *performs legal services* on the matter with the client's knowledge. [*Chambers v. Kay* (2002) 29 C4th 142, 148-150, 126 CR2d 536, 541-542—absent requisite disclosure and client consent, fee-splitting agreement between attorneys who shared work on case but who were not partners or "associates" in same firm (one was not a salaried employee of the other) unenforceable]
(b) [1:35.2] **Permissible compensation to outside lawyer:** Attorneys who encounter incorporation issues requiring specialized legal expertise occasionally bring in another lawyer who is not a partner, fellow shareholder or associate in the same firm (*see ¶ 1:3 ff.*). Compensation paid to an outside lawyer for services performed on the client's matter is not a prohibited fee split if:

• The amount paid to the outside lawyer is paid whether or not the attorney is paid by the client;

• The amount paid to the outside lawyer is neither negotiated nor based on fees paid to the attorney by the client; *and*

• The outside lawyer has no expectation of receiving a *percentage* fee. [Cal. State Bar Form.Opn. 1994-138 (also noting no prohibited fee split where outside lawyer is paid *entire* fee received by attorney upon payment by client); see *Chambers v. Kay* (2002) 29 C4th 142, 154, 126 CR2d 536, 545-546 & fn. 6]
(c) [1:35.3] **Quantum meruit recovery where fee-splitting agreement unenforceable:** A violation of CRPC 1.5.1 renders the fee-splitting agreement unenforceable; but the Rule violation does not preclude a *quantum meruit* recovery *between the lawyers* for the reasonable value of legal services rendered in reliance on the fee-sharing agreement. [*Huskinson & Brown v. Wolf* (2004) 32 C4th 453, 458-459, 9 CR3d 693, 696-697; see *Brown v. Grimes* (2011) 192 CA4th 265, 284-285, 120 CR3d 893, 909-910]
On the other hand, the client is not liable for quantum meruit fees to a lawyer with whom the client did not contract and whose services the client did not request. [*Strong v. Beydoun* (2008) 166 CA4th 1398, 1404, 83 CR3d 632, 635-636]

[1:35.4] ***Reserved.***

(3) [1:35.5] **Security arrangements for fees:** *See discussion at ¶ 1:12b ff.*

2. [1:36] **Time for Setting Fees:** The matter of legal fees should be discussed with the clients at the initial interview (*¶ 1:69*). As a matter of common sense, a fee arrangement should be made at the earliest possible time. However, delay alone does not affect the validity of the agreement.

a. [1:37] **Before accepting employment:** If the services to be rendered are predictable, it should be possible to propose a fee at the initial client interview. No attorney-client relationship yet exists and, thus, attorneys are free to negotiate in their own self-interest. [See *Setzer v. Robinson* (1962) 57 C2d 213, 216, 18 CR 524, 526; see also CRPC 1.8.1, Comment [5] (formerly CRPC 3-300, Discussion)]

b. [1:38] **After accepting employment:** Sometimes, the lawyer may want to do some research or investigation to determine what services will be required and thus what fee to charge. In such cases, fees may be left open at the initial interview, and agreement properly deferred until a later time. [See *Walton v. Broglio* (1975) 52 CA3d 400, 404, 125 CR 123, 125]

[1:39] While it is true that, once employed, the attorney is a "fiduciary" and there is a presumption of undue influence in dealing with the client (see Prob.C. § 16004(c)), that presumption does not apply to fee arrangements. Therefore, the fact that there is an existing attorney-client relationship at the time the agreement was made does *not* affect the validity of the agreement. [*Walton v. Broglio* (1975) 52 CA3d 400, 125 CR 123; see CRPC 1.8.1, Comment [5] (formerly CRPC 3-300, Discussion)]

➪ [1:40] ***PRACTICE POINTER:*** Even so, good practice dictates executing a fee agreement as soon as possible. The longer delayed, the more difficult it may become to *reach* an agreement.

[1:40.1 - 1:40.4] ***Reserved.***

c. [1:40.5] **Subsequent fee increases:** Counsel cannot unilaterally determine their own fees. Thus, agreed-upon fee rates cannot be changed mid-stream without notification to the client (presumably, giving the client an opportunity to consent or, instead, to switch attorneys). [*Severson & Werson v. Bolinger* (1991) 235 CA3d 1569, 1573, 1 CR2d 531, 533—clients who agreed to pay quoted "regular hourly rates" could not be assessed higher rates without prior notice]

3. [1:41] **Agreement re Expenses:** The initial interview should also cover whatever expenses are likely to be incurred in organizing the business entity. If the decision is made to incorporate, there will be filing fees and other expenses (*see ¶ 2:72 ff.*). Clients may be unaware of these expenses beforehand. Therefore, agreement should be reached as to (a) the attorney's authority to incur such expenses on behalf of the client; and (b) the client's obligation to pay or reimburse the attorney therefor.

➪ [1:42] ***PRACTICE POINTER:*** Be sure the client understands such expenses are *not* included in the attorney's fee. This is sometimes a source of misunderstanding with new clients who have only limited business experience. They may mistakenly assume that the fee quoted for legal services includes expenses.

a. [1:43] **Advances by client:** Wherever possible, the client should agree to deposit with the attorney sufficient funds to cover the estimated costs and expenses of organizing the business entity. Funds received from the client as a deposit on such expenses must be placed in a *client trust account*, maintained *separately* from the attorney's personal and office accounts. [CRPC 1.15(c) (formerly CRPC 4-100(A)); and see *Stevens v. State Bar* (1990) 51 C3d 283, 286-287, 289, 272 CR 167, 169, 171—attorney violated ethical rules by depositing client's $592 advance on incorporation fees and costs in attorney's operating account]

(1) [1:43.1] **Deposit in IOLTA account may be required:** Advances (and other sums received or held for clients' benefit) must be deposited in a statutorily-regulated *interest- or dividend-bearing trust account* (IOLTA account) if "nominal in amount" or deposited for a short time. [Bus. & Prof.C. § 6211(a)] The accrued interest or dividends are paid directly to the State Bar by the financial institution to fund legal services for the indigent. [See Bus. & Prof.C. §§ 6210-6228; and *Carroll v. State Bar* (1985) 166 CA3d 1193, 1198-1199, 213 CR 305, 307]

➪ [1:44] ***PRACTICE POINTER:*** As an *alternative* to dealing with trust account deposits, etc., some business lawyers ask their clients to furnish checks made payable to the Secretary of State, etc. to cover the necessary filing fees and other expenses that the attorney will be incurring. The attorney can then forward the clients' checks along with the documents being filed.

(2) [1:44.1] **Compare—"property" held for client:** CRPC 1.15(a) refers only to "funds." Hence, "property"—even though held for the benefit of clients—is not subject to the "trust account" requirement. Nevertheless, an attorney's "mishandling" of entrusted property may violate his or her general *oath and duties as an attorney* and, thus, give rise to discipline on that ground (Bus. & Prof.C. §§ 6068(a), 6103). [See *Hartford v. State Bar* (1990) 50 C3d 1139, 1154-1155, 270 CR 12, 21—disciplinary action proper under §§ 6068(a) and 6103 where attorney, without notice or authority, sold stock pledged as security for payment of fees and litigation expenses]

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

b. [1:45] **Advances by attorney:** The attorney may properly agree to advance costs and expenses on behalf of the client, as long as:

• The client agrees in writing to replay the advances;

• Repayment of the advances is contingent upon the outcome of the matter; *or*

• The matter involves representation of an indigent person. [CRPC 1.8.5(b) (formerly CRPC 4-210(A))]

4. [1:46] **Who is Responsible for Fees and Costs?** In representing several clients in forming a business, it is important to obtain a specific agreement on who is to be *billed* for the fees and costs, and who will bear *ultimate responsibility for payment*. If a corporation is to be formed, it must be made clear whether the attorney is to look to the corporation alone for his or her fees; or whether the organizers are responsible personally.

➪ [1:47] ***PRACTICE POINTER:*** Ideally, where there are several clients, the agreement will provide that they are jointly and severally responsible for legal fees and expenses. For convenience's sake, you may agree that billings will be sent only to the business or to one or fewer than all of the principals. But, wherever possible, make sure that *all* of them are ultimately responsible, if such billings are not paid. Such an understanding will avoid situations where some of the clients claim they were only obligated to pay "their share" of fees and costs, and you are unable to collect the balance from the others who may have withdrawn from the proposed venture.

[1:48 - 1:49] ***Reserved.***

5. [1:50] **Written Agreement Required:** Bus. & Prof.C. § 6148(a) requires a *written* fee agreement whenever it is *reasonably foreseeable* that the *total expense* to the client (i.e., costs plus attorney fees) will exceed $1,000. [Bus. & Prof.C. § 6148(a)]

Section 6148 applies to all attorney fee agreements, except agreements for a contingency fee (which are governed by Bus. & Prof.C. § 6147) and except in those circumstances set forth in Bus. & Prof.C. § 6148(d) (¶ 1:53.3). Thus, Bus. & Prof.C. § 6148 generally governs fee agreements pertaining to the organization of business entities. [Bus. & Prof.C. § 6148(a)]

Cross-refer: The form and content of fee agreements, discussed below (¶ 1:50.1 ff.), is addressed in greater detail in Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 5.

a. [1:50.1] **Required contents:** The agreement must contain all of the following information:

(1) The basis of compensation, including hourly rates, statutory fees or flat fees, and other standard rates, fees and charges applicable to the matter;

(2) The general nature of the legal services to be provided; and

(3) The respective responsibilities of the attorney and the client under the agreement. [Bus. & Prof.C. § 6148(a)(1)-(3)]

b. [1:51] **Optional arbitration provision:** Though not required, a provision for arbitration of attorney-client disputes *may* be included in the agreement.

(1) [1:51.1] **Fees/costs dispute arbitration:** The agreement may require that attorney fees and/or costs disputes be submitted to State Bar-administered arbitration under the Mandatory Fee Arbitration Act (MFAA, Bus. & Prof.C. § 6200 et seq.). (But the client has the right to arbitrate fees/costs disputes under the MFAA even absent a provision in the retention agreement; see Bus. & Prof.C. § 6200 et seq.)

Arbitration under the MFAA is *not binding*, and either party may request a trial de novo following the arbitration, unless the attorney and client agree otherwise *after the dispute has arisen*. [Bus. & Prof.C. §§ 6200(c), 6204(a); *Wager v. Mirzayance* (1998) 67 CA4th 1187, 1190, 79 CR2d 661, 663]

(a) [1:51.2] **Trial de novo right yields to provision for "standard" arbitration:** The client has the right to elect MFAA arbitration even if the retention agreement requires that fees/costs disputes be submitted to "standard" private arbitration. However, following nonbinding MFAA arbitration, the attorney can require that the dispute be submitted to private arbitration in accordance with the retention agreement (thus "trumping" the client's MFAA right to elect a trial de novo in a court of law). [*Schatz v. Allen Matkins Leck Gamble & Mallory LLP* (2009) 45 C4th 557, 562-563, 87 CR3d 700, 703]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) [1:51.3] **Client waiver of MFAA rights:** Clients *waive* their MFAA rights by:

- *Failing to request MFAA arbitration* within 30 days after receipt of the attorney's written notice informing them of the MFAA arbitration right. [Bus. & Prof.C. § 6201(a)]

- *Commencing an action against the attorney* seeking either judicial resolution of the fees/costs dispute or damages for attorney malpractice. [Bus. & Prof.C. § 6201(d)]

In either event, a preexisting contractual arbitration agreement between the client and attorney is enforceable against the client. [*Aguilar v. Lerner* (2004) 32 C4th 974, 989-990, 12 CR3d 287, 297; *Ervin, Cohen & Jessup, LLP v. Kassel* (2007) 147 CA4th 821, 826-828, 54 CR3d 685, 688-690]

(2) [1:52] **Legal malpractice (and other disputes) arbitration:** The agreement may also require binding arbitration of disputes regarding the lawyer's services—including malpractice claims. [See *Powers v. Dickson, Carlson & Campillo* (1997) 54 CA4th 1102, 1109, 63 CR2d 261, 264; Cal. State Bar Form.Opn. 1989-116]

(a) [1:52.1] **Ambiguity construed against attorney:** As the one who drafted the agreement, counsel bears the consequences of any ambiguity in the arbitration provision. It must *clearly* state what disputes are subject to arbitration. Any uncertainty will be resolved against counsel and, hence, against arbitration. [See *Mayhew v. Benninghoff* (1997) 53 CA4th 1365, 1370, 62 CR2d 27, 30—arbitration provision in representation agreement did not cover disputed business transaction between attorney and client; *Lawrence v. Walzer & Gabrielson* (1989) 207 CA3d 1501, 1506-1507, 256 CR 6, 9—provision requiring arbitration of disputes "regarding fees, costs, or any other aspect of our attorney-client relationship" did not cover legal malpractice claim]

(b) [1:52.2] **Warning to client:** The modern view is that an arbitration provision that is conspicuous, plain and clear does not require further explanation or disclosure to the client. [See *Mission Viejo Emergency Med. Assocs. v. Beta Healthcare Group* (2011) 197 CA4th 1146, 1156-1158, 128 CR3d 330, 338-340 (arbitration provision contained in insurance policy)]

However, for a client who is unsophisticated or who otherwise might not understand the legal effect of binding arbitration, best practices suggest that the client should be fully advised of the possible consequences: i.e., no right to court or jury trial, possible limitations on discovery, very limited appellate review, etc. [See *Wheeler v. St. Joseph Hosp.* (1976) 63 CA3d 345, 361, 133 CR 775, 786—"Absent notification and at least some explanation, the patient cannot be said to have exercised a 'real choice' in selecting arbitration over litigation" (provision in contract with hospital requiring arbitration of medical malpractice claims)]

(c) [1:52.3] **Caution—no arbitration if entire agreement void for illegality:** Where the agreement is void for illegality, the arbitration provision is likewise unenforceable. [*Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co, Inc.* (2018) 6 C5th 59, 73-86, 237 CR3d 424, 433-444—law firm's engagement letter involved conflicted concurrent representation without client's informed consent in violation of former CRPC 3-310(C)(3) (now see CRPC 1.7(a)), *discussed further at ¶ 1:9.6 ff.*]

A challenge to the legality of the entire agreement must be decided by the *court* rather than by the arbitrator. [*Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co., Inc.*, supra, 6 C5th at 74-75, 237 CR3d at 434]

Cross-refer: For a detailed discussion of contractual arbitration, see Knight, Chernick, Quinn & Gupta, *Cal. Prac. Guide: Alternative Dispute Resolution* (TRG), Ch. 5. See also Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 5.

c. [1:53] **Execution of agreement; conformed copy to client:** At the time the agreement is entered into, the attorney must provide the client with a duplicate copy signed by both the attorney and client. [Bus. & Prof.C. § 6148(a)]

This, of course, presumes that the agreement has been signed by the parties. "[T]he fact that an alleged attorney fee contract has not been signed by anyone does not constitute a technicality, but a material failure to comply with a crucial statutory requirement … When an alleged agreement has not been signed by anyone, we are left to speculate about the client's understanding of the situation." [*Leighton v. Forster* (2017) 8 CA5th 467, 484-485, 213 CR3d 899, 913—written fee agreement signed by neither client nor attorney unenforceable despite attorney's rendering of substantial services thereunder]

d. [1:53.1] **Fee agreement voidable for noncompliance:** If a written fee agreement is required, an oral fee agreement (or written agreement that does not meet the above requirements; *see* ¶ 1:50 ff.) is *voidable* at the option of the client. [Bus. &

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Prof.C. § 6148(c); see *Leighton v. Forster* (2017) 8 CA5th 467, 488, 213 CR3d 899, 915—§ 6148(c) does not require client to formally rescind agreement]

If the client chooses to void the agreement, the attorney is entitled only to collect "a *reasonable* fee" (i.e., prior understandings will be unenforceable). [Bus. & Prof.C. § 6148(c)]

[1:53.2] ***Reserved.***

e. [1:53.3] **Exceptions:** However, a written agreement is not required if:

- The attorney renders services in an *emergency*, or where a writing is otherwise impractical; or

- The fee arrangement is *implied* from the fact that the attorney's services are of the same general kind as previously rendered to and paid for by the client; or

- The client makes a *knowing written waiver* after full disclosure of the requirement of a written fee agreement; or

- The client is a *corporation.* [Bus. & Prof.C. § 6148(d); see *Leighton v. Forster* (2017) 8 CA5th 467, 488-489, 213 CR3d 899, 915-917—"implied agreement" exception did not apply where attorney's services were not of same general kind as previously rendered to and paid for by client's husband]

(1) [1:53.4] **Comment:** Even where not required, a written agreement is strongly recommended. Most attorney-client disputes arise over misunderstandings about fees and costs; and most such disputes result from failure to put the essential terms in *writing*.

FORM: Engagement Letter, *see Form 1:A*.

[1:53.5 - 1:53.6] ***Reserved.***

6. Billing Requirements

a. [1:53.7] **When billed:** The agreement with the clients should specify when they will be billed (e.g., on a monthly basis). Clients may request billings at 30-day intervals following any initial request, and counsel ordinarily must comply within 10 days thereafter. However, if a bill was given within 31 days before the client's request, counsel has up to 31 days from the date of the previous bill in which to provide a new one. [Bus. & Prof.C. § 6148(b)]

b. [1:53.8] **Billing information:** All client bills must clearly state the basis on which they are calculated, and must segregate fees and expense items. [Bus. & Prof.C. § 6148(b)] Specifically:

- The "fee portion" of the bill must include the "amount, rate, basis for calculation," or other method of determining "the attorney's fees and costs." [Bus. & Prof.C. § 6148(b)]

- The "cost and expense" portion of the bill must "clearly identify" the cost and expense items and the amount thereof. [Bus. & Prof.C. § 6148(b)]

Fees or costs that cannot be accurately determined as of the date of the client's billing request must be "described and estimated"; otherwise, counsel may use billing data that is "currently effective on the date of the request." [Bus. & Prof.C. § 6148(b)]

c. [1:53.9] **Failure to comply:** Failure to comply with the above billing requirements (¶ 1:53.7 ff.) may render the fee agreement *unenforceable*. [Bus. & Prof.C. § 6148(c); ¶ *1:53.1*]

7. [1:54] **Fees Payable in Installments:** The fee agreement may provide for a fixed fee for incorporation services, payable in installments on specified dates.

a. [1:54.1] **Effect of client's failure to pay installment:** Where a fixed fee has been agreed upon, payable in installments, the client's failure to pay one or more installments does not by itself excuse the attorney from performing.

Preliminarily, it is a question of contract law whether the nonpayment constitutes a material breach. But even when the breach is material, as an ethical matter a lawyer may withdraw from representing the client only if the lawyer gives the client a *reasonable warning* that the lawyer will withdraw unless the client fulfills the agreement or performs the obligation. [See CRPC 1.16(b)(5) (formerly CRPC 3-700(C)(1)(f))]

b. [1:54.2] **Effect of truth-in-lending laws:** If a fixed fee is payable in *more than four* installments (excluding any down payment), the attorney may be required to comply with federal truth-in-lending regulations. [See 12 CFR § 226.2(a)(17)(i)]

8. [1:54.3] **Interest Charges:** The agreement with the client may authorize charging of interest on unpaid fees; there is nothing ethically improper in so doing.

Even without such an agreement, interest can be recovered at the legal rate from the time the services were completed, through legal action if necessary. [Civ.C. § 3287]

9. [1:54.4] **Client's Federal Tax Obligation to Report Fees:** A person engaged in a trade or business and who, in any taxable year, pays $600 or more to an attorney (including a law corporation or partnership) in connection with legal services must report the total on IRS Form 1099. Attorneys are not required to inform clients of this obligation; however, upon request, attorneys must promptly supply their taxpayer identification number to clients or others making payment to the attorney. [IRC §§ 6041(a), 6045(f)]

➪ [1:54.4a] ***PRACTICE POINTER:*** Attorneys should volunteer this information to those clients who might not be aware of the reporting requirement. Otherwise, an unknowing client hit with IRS penalties may become annoyed with the attorney (who, because he or she did not receive the 1099, "should have known" the client was not complying with the law).

10. [1:54.5] **Recourse to Client Trust Account for Payment of Fees:** As indicated earlier, funds received on behalf of a client (e.g., corporate distribution proceeds, refundable fee prepayments, costs advances, etc.) must be deposited in a client trust account kept *segregated* from funds belonging to counsel (CRPC 1.15(a), ¶ *1:20.1, 1:43 ff.*).

If the funds so deposited belong "presently or potentially" in part to counsel, the portion belonging to counsel must be withdrawn "at the earliest reasonable time" after counsel's interest therein becomes "fixed." On the other hand, even though concededly owed reimbursement for legal services rendered, counsel *cannot unilaterally* invade the trust account in payment of fees where the amount owed to counsel is *disputed* (doing so would violate the prohibition on counsel's unilaterally determining his or her own fees, ¶ *1:40.5*). Instead, the disputed portion "shall not be withdrawn" until the dispute is "finally resolved." [CRPC 1.15(c)(2) (formerly CRPC 4-100(A)(2)); see *McKnight v. State Bar* (1991) 53 C3d 1025, 1036-1037, 281 CR 766, 773—attorney unilaterally deposited one-half of client's corporate dissolution proceeds in attorney's personal account to pay legal fees; *In re Davis* (Rev.Dept. 2003) 4 Cal. State Bar Ct.Rptr. 576, 586-587—attorney retained by director/president of deadlocked corporation to act as corporate counsel despite opposition by majority of directors (*see* ¶ *1:11.1e*) unilaterally transferred portion of corporate funds from trust account to attorney's personal account to pay disputed legal fees]

Cross-refer: For a detailed discussion of attorney obligations regarding client funds/property and client trust accounts, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 9.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 1-C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 1. Preliminary Considerations

C. Initial Client Interview

1. [1:55] Importance
2. [1:56] Overall Objectives
3. [1:57] Preparing for Initial Interview
    a. [1:58] Set aside enough time
    b. [1:59] Determine referral source
    c. [1:60] Do some preliminary digging
4. [1:61] Conducting the Interview
    a. [1:62] Put clients at ease
    b. [1:63] Encourage clients to talk first
    c. [1:64] Use a checklist for relevant information
    d. [1:65] Avoid giving piecemeal advice
    e. [1:66] Determine points of agreement and disagreement
        (1) [1:67] *CAUTION*
    f. [1:68] Explain alternatives
    g. [1:69] Discuss legal fees and costs
5. [1:70] Counseling During Initial Interview
    a. [1:71] Principal matters for decision
        (1) [1:72] Choice of business entity
        (2) [1:73] Valuation of contributions
        (3) [1:74] Debt vs. equity
        (4) [1:75] Allocating management and control
    b. [1:76] Clients may be unable to decide at time of initial interview
6. [1:78] Concluding the Initial Interview
    a. [1:79] Restate scope of work undertaken
    b. [1:80] Restate fee and costs arrangements
    c. [1:81] Restate whatever additional information required
    d. [1:82] Further communications with clients

1. [1:55] **Importance:** The initial interview with prospective business clients is usually crucial to a successful attorney-client relationship. The clients will normally decide whether they want to hire the attorney, and the attorney whether they want to accept such employment, on the basis of the impressions gained of each other at the initial interview. If the initial interview is unfavorable, there often will be no second chance.

2. [1:56] **Overall Objectives:** In general, the initial meeting with prospective clients should accomplish the following:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Afford the clients full opportunity to express their objectives and concerns;

• Begin the process of collecting relevant data and information necessary for the attorney to render advice;

• Begin the analytic process of exploring alternatives available to the clients in light of their expressed objectives and the information initially obtained; and

• Develop attorney-client attitudes of trust and confidence as a basis for future dealings.

3. [1:57] **Preparing for Initial Interview:** The best way of assuring a successful interview with new clients is to prepare for it. Here are some suggestions:

a. [1:58] **Set aside enough time:** Even a relatively straightforward interview with new clients on a proposed business may take several hours. Make sure your calendar is clear (and is kept clear) so that the clients will not feel rushed or that you are "too busy" for them.

If you anticipate that the interview may require the assistance of others in the office (e.g., paralegals or tax counsel), check their calendars to make sure that they can be present.

b. [1:59] **Determine referral source:** When prospective clients request an interview, you should ask who referred them to you. This will enable you to send that person a thank-you letter or email for the referral (which usually serves to encourage future referrals). Also, you may find it helpful to contact the referral source for information regarding the new clients; e.g., their reputations, creditworthiness, business backgrounds, etc.

c. [1:60] **Do some preliminary digging:** Find out what you can regarding the clients and their proposed business venture before the interview. Internet searches can turn up a wealth of information. Try to find out a little about the business they are in, or propose to engage in, and the kinds of problems likely to be encountered.

4. [1:61] **Conducting the Interview:** Lawyer interviewing techniques vary widely, but the following guidelines are usually helpful:

a. [1:62] **Put clients at ease:** It is generally a good idea to open the interview with mention of common acquaintances, or other pleasantries. Serving coffee or tea (for in-person meetings) is usually helpful in breaking the ice and putting new clients at ease.

b. [1:63] **Encourage clients to talk first:** Encourage the clients to articulate their objectives regarding the new business, and whatever concerns they may have. Prod them, if necessary, to express their concerns fully ("Is there anything about this transaction that is troubling you?"). Listen, *really listen*, to what the clients say.

c. [1:64] **Use a checklist for relevant information:** Many lawyers find it helpful to use a structured approach to gather information regarding the clients and their proposed business venture. A checklist or interview sheet can be used to make sure that you ask for *all* the information you may need in order to advise the client and handle the organizational work.

• ***FORM:*** Checklist for Initial Client Interview, *see Form 1:B*.

d. [1:65] **Avoid giving piecemeal advice:** Sometimes, clients ask for an opinion after giving you only part of the facts, or only such information as they think to be important. You should generally defer giving *any* advice until you are satisfied that you understand the clients' objectives and concerns, and have ascertained all relevant information. Quite frequently, you may need to consult with accountants, tax specialists or other experts, so that your advice must necessarily be deferred until a later time.

e. [1:66] **Determine points of agreement and disagreement:** In analyzing the information obtained from the clients, note the points upon which they agree, and the points upon which they disagree. Also, focus on any points that they have not yet considered—i.e., the potential "holes" in the deal. If important matters are still in dispute or not yet considered, any advice or expression of opinion by counsel would be premature.

(1) [1:67] ***CAUTION:*** There are ethical limitations on accepting employment by clients whose interests conflict (*see ¶ 1:9 ff.*). The more areas of disagreement between the clients, the more likely that such a conflict exists. If they ultimately fail to reach an agreement, the lawyer may be disqualified from representing either party in a dispute with the other.

f. [1:68] **Explain alternatives:** Without necessarily rendering an opinion as to the best or optimum plan, you should identify for the clients the various options available for their business venture, and the basic tax and nontax consequences of each

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

alternative. You may need to defer any final expression of opinion until you have reviewed financial data, consulted with accountants or tax specialists, etc.

g. [1:69] **Discuss legal fees and costs:** The initial interview *must* include a candid discussion of the fees that you will charge and the costs likely to be incurred in connection with the proposed venture; *see ¶ 1:36 ff.*

5. [1:70] **Counseling During Initial Interview:** Ultimately, of course, all decisions regarding the business entity (i.e., its form, how structured as to ownership and management, sharing in profits, etc.) must be made by the client or clients. Counsel's responsibility is to *explain* the alternatives available, and to *assist* the clients in reaching these decisions (based on their stated objectives and other information obtained from them).

a. [1:71] **Principal matters for decision:** The principal points for decision by clients seeking to organize a business entity usually are as follows:

(1) [1:72] **Choice of business entity:** First of all, will it be a sole proprietorship, partnership (general, limited or limited liability), limited liability company (LLC) or corporation? This is a threshold decision and can properly be made only after the clients have fully considered all the tax and nontax factors referred to at *¶ 2:44 ff.*

(2) [1:73] **Valuation of contributions:** Where a partnership, LLC or corporation is decided upon, and it is contemplated that ownership or profits may be allocated for *services or property* contributed by some or all of the clients, agreement must be reached on the value of such contributions. *See ¶ 1:84 ff.*

(3) [1:74] **Debt vs. equity:** Also, where a partnership, LLC or corporation is decided upon, the clients must decide how much of their respective contributions is to be "loaned" to the business, and how much is being invested as "capital" (or "equity"). The importance of this decision is discussed at *¶ 3:14 ff.*

(4) [1:75] **Allocating management and control:** Where several clients are involved, they must decide how they intend to participate in management of the business—i.e., what matters shall require majority or unanimous consent; who shall have what voice or say in day-to-day operations; what to do in event of disagreement, etc. *See ¶ 3:160 ff.*

b. [1:76] **Clients may be unable to decide at time of initial interview:** It is not always possible for the client or clients to make such decisions during the initial interview. Sometimes, they are unable to provide all of the relevant data you need in order to render an opinion. Often (especially where there are several clients), you may have raised questions which they had not previously considered. In such cases, the clients need time to consider such matters, and possibly even to negotiate further among themselves. Final decisions will have to be deferred until subsequent interviews or telephone conferences.

➪ [1:77] ***PRACTICE POINTERS:*** Avoid rushing the clients' decisions. Encourage them to "sleep on it" or talk to their spouses, etc. This often saves false starts in preparing agreements or documentation which are ultimately scrapped (and which run up unnecessary fees and costs).

At the same time, clients often *expect you to make recommendations* to them (as opposed to simply pointing out a field of alternatives, and saying "You decide."). If you do so, however, be sure to emphasize to the clients that these are simply suggestions based on your experience; that it is up to the clients to make the decisions; and that you will not be offended if they choose to ignore your suggestions.

6. [1:78] **Concluding the Initial Interview:** At the conclusion of the initial interview, it is good practice to summarize what has been agreed upon, the next steps counsel intends to take, and the next action expected of the clients. Here are some guidelines:

a. [1:79] **Restate scope of work undertaken:** First of all, restate specifically what services you are going to render; what, if any, matters will be undertaken in consultation or association with specialists or other experts; and what, if any, matters are being deferred entirely to other experts.

b. [1:80] **Restate fee and costs arrangements:** If it was possible to come to an agreement on fees and costs, briefly restate its terms. If the matter is still open, make sure the clients understand that fees *will* be charged for the initial interview (if that is your intent), as part of whatever fee agreement is subsequently reached.

c. [1:81] **Restate whatever additional information required:** It is a good idea to prepare a list of precisely what facts or data you still need in order to advise the clients. If there are several clients, find out which is responsible for furnishing what information. Suggest a timetable for their providing this additional information.

d. [1:82] **Further communications with clients:** State that you will be sending them an engagement letter to be signed by each of them, and then returned to you. Also, reach an understanding with them whether further communications are to be

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

with all of the clients, or whether you may communicate with less than all of them concerning any future questions you may have or advice you may give.

➪ [1:83] ***PRACTICE POINTER:*** When in doubt, communicate with *all* of the clients. Doing so tends to cement your relationship with each of the organizers, rather than simply with one of them. Particularly with written communications, send each of them copies of letters, emails or documents you send to any one of them (unless, of course, they specifically tell you otherwise).

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 1-D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 1. Preliminary Considerations

D. Valuing Noncash Contributions by the Parties

- 1. [1:84] Need for Valuation of Noncash Contributions
    - a. [1:85] Partnerships and LLCs
    - b. [1:86] Corporations
        - (1) [1:87] Lawful consideration for issuance of shares
        - (2) [1:88] Determining value of noncash consideration
        - (3) [1:89] Example
    - c. [1:90] Compare—valuation for other purposes
        - (1) [1:91] Death taxes
            - (a) [1:92] Sole proprietorship
            - (b) [1:93] Partnership, LLC or corporation
        - (2) [1:94] Gift taxes
        - (3) [1:95] Dissolution proceedings
        - (4) [1:96] Buy-out of one partner, LLC member or shareholder
        - (5) [1:97] Sale of business
        - (6) [1:98] Financing
- 2. [1:99] Attorney's Role in Valuation
    - a. [1:100] Sources of information re valuation
        - (1) [1:101] Tangible property
        - (2) [1:102] Intangible property
    - b. [1:103] Alert clients to possible need for future valuation
    - c. [1:105] If clients disagree on present value
- 3. [1:107] Valuation of Going Business
    - a. [1:108] Methods in general
        - (1) [1:108.1] Special considerations in valuing closely-held stock
            - (a) [1:108.2] Impact of resale restrictions
    - b. [1:109] Asset valuation method
        - (1) [1:110] Book value
            - (a) [1:111] For certain assets, book value…
            - (b) [1:112] Sometimes, book value is too…
        - (2) [1:113] Adjusted book value
            - (a) [1:114] To determine current market value,…
            - (b) [1:115] It is often necessary to…
        - (3) [1:116] Liquidation value

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(4) [1:117] Limitations on usefulness of asset valuation method
c. [1:118] Earnings valuation method
(1) [1:119] Method, in general
(a) [1:120] First, determining the business' true…
(b) [1:121] Second, capitalizing those earnings to…
(2) [1:122] Determining earning power
(a) [1:123] Adjustments to income statements
1) [1:124] For example, in analyzing past…
2) [1:125] Likewise, adjustments may be appropriate…
(b) [1:127] New business; future earnings
(c) [1:128] Before tax vs. after tax profits
(3) [1:129] Determining capitalization rate
(a) [1:130] Where earnings highly secure
1) [1:131] Example
(b) [1:132] Where earnings less secure
1) [1:133] Rates of return available elsewhere
2) [1:134] Comparable risk factors
(4) [1:135] Capitalization of "excess" earnings method ("formula" approach)
(a) [1:136] Example
(b) [1:137] Comment

1. [1:84] **Need for Valuation of Noncash Contributions:** During the initial client interview, counsel should determine who is contributing what to the proposed business venture. If (as often is the case) one or more of the parties proposes to contribute services or property rather than cash, it will be necessary to put a dollar value on such contributions in order to plan the financial structure of the business entity and to allocate ownership interests among the parties.

a. [1:85] **Partnerships and LLCs:** In the case of a pass-through entity, such as a partnership or LLC, noncash assets contributed by one or more of the partners or LLC members must be given a cash value in order to credit a specific amount to the *capital account* of the contributing partner or LLC member.

For example, suppose A and B are starting a new business in partnership; A will invest cash, and B will invest certain real estate owned by him. A and B must reach agreement on the value of the real estate B is contributing in order to establish the dollar value of B's capital account.

b. [1:86] **Corporations:** A corporation may acquire noncash assets from its promoters or principals in exchange for either shares of its stock or debt securities. In either case, a cash value has to be established for such assets in order to determine the amount of shares to be issued, or debt to repay.

(1) [1:87] **Lawful consideration for issuance of shares:** A corporation may issue shares for cash, or for "labor done; *services actually rendered* to the corporation or for its benefit or in its formation … *and tangible or intangible property* … but neither promissory notes of the purchaser … nor future services shall constitute payment or part payment for shares of the corporation …" [Corps.C. § 409(a)(1), *discussed at ¶ 3:307 ff.*]

(2) [1:88] **Determining value of noncash consideration:** Shares may be issued in such amounts as the board of directors determines to be reasonable for services or property other than cash. The board must, however, state by resolution its determination of the monetary value to the corporation of such noncash consideration. [Corps.C. § 409(e); *see ¶ 4:460*]

(3) [1:89] **Example:** X decides to incorporate his sole proprietorship business. The business consists of various noncash assets (inventory, equipment, goodwill) which he proposes to transfer to the corporation, along with certain liabilities (accounts payable). The board of directors must determine, by resolution, the value of the noncash assets being transferred to the corporation. If it determines in good faith that they are worth $100,000, and the accounts payable total $20,000, the corporation will issue shares having a value of $80,000. The opening balance sheet of the corporation will show:

Assets	$100,000	Liabilities	$ 20,000
		Capital stock	$ 80,000

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

$100,000

c. [1:90] **Compare—valuation for other purposes:** The discussion herein deals primarily with valuation of noncash assets in organizing a new business entity. The values assigned by the partners, LLC members or incorporators at the time of formation, however, may be different than the values later assigned to such assets for other purposes. Examples:

(1) [1:91] **Death taxes:** The noncash assets of a business have to be valued upon the death of the owner to determine federal and state death taxes.

(a) [1:92] **Sole proprietorship:** If the business was operated as a sole proprietorship, the value of the decedent's estate includes the business assets minus liabilities. If the business terminates on the proprietor's death, the noncash assets are usually valued conservatively (they may be difficult to sell if not part of a going business); there may be *no* value assigned to goodwill in such a case.

(b) [1:93] **Partnership, LLC or corporation:** On the other hand, if the business is a partnership, LLC or corporation, the assets themselves are *not* part of the decedent's estate. Rather, the estate includes the decedent's partnership interest, LLC interest or corporate shares. Still, in determining the *value* of such interest or shares, it is usually necessary to value the business assets and liabilities (unless the business is large enough that the shares are publicly traded so that their market value can be readily ascertained). The death of one partner, LLC member or shareholder normally does not cause termination of the business, so that the assets may be valued as part of an ongoing entity, and goodwill may be included.

(2) [1:94] **Gift taxes:** Similarly, gifts of business assets or interests in a business (e.g., gift of shares of corporation owning business) may subject the donor to federal gift taxes. The assets of the business (including goodwill) have to be valued in determining the amount of the taxable gift.

(3) [1:95] **Dissolution proceedings:** Valuation of business assets or interests in a business is frequently encountered in marital dissolution proceedings; and also in dissolution of a partnership, LLC or corporation.

In marital dissolution proceedings, the business is usually an ongoing entity; valuation of goodwill is often an important element. In corporation, LLC or partnership dissolutions, the business itself often is terminated, in which event the noncash assets are *not* valued as part of a going business, and goodwill may have little value.

(4) [1:96] **Buy-out of one partner, LLC member or shareholder:** If one of several partners, LLC members or shareholders decides to leave the business and the others decide to buy out his or her interest, the assets and liabilities have to be determined. (Buy-out agreements often are negotiated in advance to provide a formula for determining value in such eventuality; *see* *¶ 3:187 ff.*)

Note: In certain circumstances where one or more shareholders seek to dissolve the corporation, dissolution may be avoided by buying out their shares for cash at "fair value"—i.e., liquidation value, but taking into account any possibility of sale of the entire business as a going concern in a liquidation (*see* *¶ 8:861 ff.*).

(5) [1:97] **Sale of business:** The value of the noncash assets (especially goodwill) is usually a major factor in determining the sales price of the business. As part of an ongoing business, such assets are likely to receive a higher valuation.

(6) [1:98] **Financing:** Valuation of business assets is also frequently required in connection with bank loans or other financing transactions (secured or unsecured). Lenders usually focus on the value of "hard" assets; i.e., inventory, accounts receivable, equipment, real estate. Goodwill and other intangibles (copyrights, patents, trademarks, etc.) are not usually assigned much value by lenders.

2. [1:99] **Attorney's Role in Valuation:** The attorney's role is to explain to the clients the need for valuation of noncash assets in organizing the business entity, and to assist the clients in determining such values. The ultimate decision on valuation, of course, rests with the clients.

a. [1:100] **Sources of information re valuation:** To assist the clients in valuing noncash assets being contributed to the business, the attorney may find it appropriate to consult with (or refer the clients to) qualified appraisers or other sources of information.

(1) [1:101] **Tangible property:** The value of certain tangible property may be relatively easy to ascertain. For example, the value of a used car or truck can usually be determined from the "blue book" or by asking bank officers or lenders who regularly finance purchases of such vehicles. Similarly, the value of real estate can usually be determined by consulting with qualified real estate appraisers in the community.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [1:102] **Intangible property:** On the other hand, valuing intangible property to be used in a new business (e.g., licenses, trade names, patents, copyrights, contracts, inventions, proprietary know-how, customer lists, goodwill, etc.) is usually difficult and complex. This often requires economic appraisals and projections based upon comparable assets used in other competitive businesses.

b. [1:103] **Alert clients to possible need for future valuation:** The attorney's role is also to explain to clients forming a new business the possible need to determine the value of the business assets in the future; e.g., upon the death, withdrawal or retirement of one of the principals.

➪ [1:104] ***PRACTICE POINTER:*** Encourage the clients to enter into "buy-out" agreements, setting a price or at least a formula for calculation of the price to be paid (*see* ¶ *3:226*). Absent such agreement, valuation of the business on death, retirement, withdrawal (or expulsion) of one of the principals is often expensive and controversial.

c. [1:105] **If clients disagree on present value:** If the clients are in disagreement as to the value of some property that one of them is contributing to the venture, it may be necessary to hold up on formation of the business entity. Until agreement on valuation is reached, it usually will be impossible to allocate ownership interests between the clients. Counsel should encourage the parties to negotiate between themselves to resolve their disagreement, or to agree upon a neutral appraiser or expert for valuation purposes.

➪ [1:106] ***PRACTICE POINTERS:*** If the parties still disagree, you might suggest that the client who is transferring the property *warrant its value* to the new business entity. (Such a warranty may be useful, for example, in connection with accounts receivable, where there are questions as to collectibility.) The warranty will permit the parties to proceed with formation of their venture, and allow later adjustment between them if the valuation agreed upon proves inaccurate.

Another alternative: Suggest to the clients that the owner-client *retain* title to whatever assets are of disputed value. If those assets are deemed essential to operation of the business, the new venture can agree to pay a fair *rental*.

3. [1:107] **Valuation of Going Business:** While an attorney is not expected to be an expert on business asset valuation, the attorney should understand the basic methods by which such assets are valued. This will facilitate communicating with any appraiser employed by the clients, and assisting the clients in reaching their final decisions on valuation.

a. [1:108] **Methods in general:** While no set formula exists, there are two methods commonly employed by appraisers in determining a business' worth: (a) *asset valuation* and (b) *capitalized earnings valuation*.

Often, *both* methods are used and the resultant valuations weighed together in arriving at the ultimate "fair market value" determination. Thus, for estate tax purposes, the IRS Regulations provide:

> "The fair market value of any interest of a decedent in a business, whether a partnership or a proprietorship, is the net amount which a willing purchaser whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The net value is determined on the basis of all relevant factors including—
>
> "(a) A fair appraisal as of the applicable valuation date of *all the assets* of the business, tangible and intangible, including good will;
>
> "(b) The demonstrated *earning* capacity of the business …" [Treas.Reg. § 20.2031-3 (emphasis added)]

(1) [1:108.1] **Special considerations in valuing closely-held stock:** Valuation can prove especially difficult for small closely-held corporations whose shares are not actively traded and thus have no established market value. In such cases, *all* the following relevant factors may have to be considered:

• The nature of the business and history of the company from its inception;

• The economic outlook in general and for the specific industry;

• The stock's book value (¶ *1:110 ff.*) and the company's financial condition;

• The company's earning capacity (*¶ 1:118 ff.*);

• The company's dividend paying capacity;

• The value of goodwill and other intangibles;

• Other stock sales and the size of the block to be valued; and

• The market price of actively traded stocks of corporations engaged in the same or similar business (*¶ 1:130 ff.*). [Rev.Rul. 59-60, 1959-1 CB 237; *Ronald v. 4-C's Electronic Packaging, Inc.* (1985) 168 CA3d 290, 299-301, 214 CR 225, 231-232 (requiring consideration of all such factors for "buy-out" in involuntary dissolution of closely-held corporation, *¶ 8:872 ff.*); compare *Trahan v. Trahan* (2002) 99 CA4th 62, 71-77, 120 CR2d 814, 820-825—valuation performed as of specific date properly excluded future profits from executory construction contracts (*see ¶ 1:117*)]

(a) [1:108.2] **Impact of resale restrictions:** The fact the shares are subject to resale restrictions (e.g., a buy-out agreement, *see ¶ 3:187 ff.*) must also be considered in valuing closely-held stock. [*Marriage of Micalizio* (1988) 199 CA3d 662, 674-675, 245 CR 673, 681; *Marriage of Rosan* (1972) 24 CA3d 885, 891, 101 CR 295, 299]

b. [1:109] **Asset valuation method:** Businesses are often evaluated according to their net worth; i.e., their total assets (what they own) minus their total liabilities (what they owe).

As discussed below (¶ 1:110 ff.), business assets may have *different* values for different purposes: i.e., *book value*, *liquidation value* or *replacement value* (reproduction value). For example, if the business is to be discontinued, it may be appropriate to consider only liquidation value. But, more typically, where the business is to be continued, assets are generally valued at their *adjusted book value*; *see ¶ 1:113*.

(1) [1:110] **Book value:** Book value is the *cost of the asset, less accumulated depreciation or reserves, as shown on the balance sheet* of the business. Book value is generally useful as a starting point in determining asset values because it shows the actual cost of purchase or production. However, book value rarely reflects accurate present valuations. Its usefulness depends on the nature of the asset and the correctness of the write offs taken.

(a) [1:111] For certain assets, book value may be too high (i.e., *overstates* current value). Examples: accounts receivable shown at face value without adequate reserves for uncollectible accounts or returns; or inventory shown at cost of production, without reserves for unsaleable or damaged merchandise. Moreover, assets that cannot be transferred may have a book value but nevertheless may have no value to a purchaser; e.g., nontransferable licenses or permits.

(b) [1:112] Sometimes, book value is too low (i.e., *understates* current value) because the assets have appreciated in value, and are in fact worth more than they originally cost (reduced by any applicable depreciation). This is commonly encountered with land and buildings that have been owned for a long period of time.

(2) [1:113] **Adjusted book value:** The generally preferred method for evaluating the assets of an ongoing business is to *adjust* the book values of various business assets to their current *market* value. This brings into focus both increases and decreases in worth of various business assets, and more accurately reflects their real value to a purchaser of the business.

(a) [1:114] To determine current market value, the parties should refer to present reproduction or replacement costs. But this is not necessarily determinative. "Market" value means what a willing buyer and a willing seller would agree upon for the asset in its present condition, and under present market conditions.

(b) [1:115] It is often necessary to engage appraisers and other experts to assist the parties in determining "market" value.

(3) [1:116] **Liquidation value:** Liquidation value is the amount at which it is estimated that business assets could be sold for *cash* in a "quick sale"; i.e., a minimum, readily-obtainable price.

Liquidation value is important for *financing* purposes; lenders are often concerned with the "quick sale value" of the borrower's machinery, equipment, inventory, etc. Also, liquidation value may be a valid method for valuing a business which is being discontinued (e.g., on death of the sole owner, or in dissolution of a partnership).

But it is generally *not* a fair measure of valuing assets being utilized by an ongoing business.

(4) [1:117] **Limitations on usefulness of asset valuation method:** Asset valuation alone does not always provide a fair measure of the value of a going business. Value often depends in major part on intangible assets which may not even be shown on the balance sheet (and thus have no book value)—e.g., goodwill, customer lists, contracts and proprietary know-how. A going business, therefore, may be worth more than the book value of its assets minus liabilities … because

assets operating in combination with non-balance sheet intangibles can produce earnings *substantially in excess of what the balance sheet might otherwise indicate*. For this reason, the asset valuation method is frequently used in conjunction with the earnings valuation method discussed below (¶ 1:118). [See *Trahan v. Trahan* (2002) 99 CA4th 62, 65-71, 120 CR2d 814, 816-820—valuation that disregarded $650,000 future gross profits from executory construction contracts produced $164,000 *negative* net worth]

c. [1:118] **Earnings valuation method:** In most cases, the person evaluating a business wants to know what rate of return it will produce on the amount invested. Probably the best way to answer this question is to determine the *earning power* of the business, and then determine what rate of return those predicted earnings represent in light of the risks involved to attain them. This is called *capitalized earnings valuation*.

(1) [1:119] **Method, in general:** A capitalized earnings valuation requires multiplying the projected earnings from the business by a price-earnings (capitalization) ratio. Thus, two steps are involved:

(a) [1:120] First, determining the business' true earning power, based both upon its past experience and future probabilities; and

(b) [1:121] Second, capitalizing those earnings to reflect a rate of return that is realistic for the risks involved under present economic conditions.

(2) [1:122] **Determining earning power:** The first step is to determine the earnings history of the business—i.e., its past operating income less expenses. Such earnings history usually can be ascertained from the income statements and tax returns kept by the business.

(a) [1:123] **Adjustments to income statements:** Here again, however, in analyzing past profit-and-loss statements, it is often necessary to *adjust* various items of income or expense to arrive at the business' realistic earning power.

1) [1:124] For example, in analyzing past income statements, *nonrecurring* items of income or expense should be eliminated. (For example, gain or losses on sale of business assets or investments.)

2) [1:125] Likewise, adjustments may be appropriate where executive *salary expense* is *unrealistically* high or low. (Unrealistically high salaries represent a distribution of profits, rather than a normal expense, and should be adjusted to reflect the reasonable value of the employee's services … thus *increasing* the profit potential of the business. Unrealistically low salaries represent a contribution of services by the employees involved, and should be adjusted upward … thus *decreasing* the profitability of the business—because it is unrealistic to value a business based on future gifts of services from employees.)

➪ [1:126] ***PRACTICE POINTER:*** This is a frequent source of disagreement in valuing a small business. The proprietors often fail to consider the value of their own time and efforts—and the cost of replacing them—in determining the earning power of the business.

(b) [1:127] **New business; future earnings:** The newer the business, the more difficult it is to predict future earnings. The lack of historical earnings makes it difficult to base future earnings projections on the profits for whatever period of time the business has been operating.

Obviously, this does not apply to new corporations, LLCs or partnerships that have acquired other businesses with an established history of earnings. For example, if a sole proprietorship with years of successful operation is incorporated, the new corporation's profits can safely be predicted based on the proprietorship's former profits (with adjustments perhaps for different tax rates; *see ¶ 2:98 ff.*).

(c) [1:128] **Before tax vs. after tax profits:** Ordinarily, it is the *after-tax* profit that is capitalized in determining the business' earning power.

However, this too is a matter that may be negotiated, and sometimes pre-tax profits are used. Even where after-tax profits are capitalized, adjustments may be appropriate. (For example, the after-tax profits may be unrealistically low where inventory has been overstated or salaries have been unrealistically high.)

(3) [1:129] **Determining capitalization rate:** Once the earnings power of the business is determined, the appropriate price-earnings ratio must be ascertained; i.e., the multiple to use in "capitalizing" those earnings.

The price-earnings ratio is a matter of judgment, but should reflect two factors: (a) the *degree of risk* that the earnings will be less than predicted; and (b) what constitutes a *fair rate of return* on the amount invested. In other words, the value of the business ultimately depends on the *predictability* of its earnings and prevailing rates of return available elsewhere on similar investments of similar risk and potential. [See, e.g., Rev.Rul. 59-60, 1959-1 CB 237]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [1:130] **Where earnings highly secure:** If the business has a *proven* earnings history and the *ability to compete with publicly-traded companies* in the same field, it may be appropriate to use the price-earnings ratio at which the public companies' stock is traded.

1) [1:131] **Example:** Suppose A's sole proprietorship has a consistent earnings history of $500,000 per year. Suppose further that it has shown its ability to compete successfully with publicly-traded companies in the same field. If A's business were incorporated and paying tax at the same rate as its competitors (assume 21% corporate rate, *¶ 2:102*), the after-tax earnings would be $395,000. If the shares of the public companies with which A competes are presently selling for an average of 10 times earnings, A's business should be capitalized at the same rate; i.e., 10 times $395,000 or $3,950,000.

(b) [1:132] **Where earnings less secure:** It is not appropriate to rely on the price-earnings ratio at which the stock of public companies is traded where the business involved has no proven ability to compete with such companies. Instead, the capitalization rate should be determined from the *rates of return available on other long-term investments involving comparable risk*.

1) [1:133] **Rates of return available elsewhere:** First of all, the capitalization rate must reflect the rate of return available on other long-term investments. E.g., if other long-term investments involving comparable risk are yielding 7%, the capitalization rate would be 7%, giving an investment value of 14.3 times projected earnings.

2) [1:134] **Comparable risk factors:** It is inappropriate to adopt the rate of return on U.S. Government bonds or insured investments in capitalizing the earnings of a small, privately held business. The rate of return must reflect comparable risk factors. Thus, the value of the business will depend on the *degree* of risk in its projected earnings. If the risk is comparable to that in buying speculative bonds or second trust deeds, a comparable rate of return will be demanded. E.g., if speculative bonds or second trust deeds currently yield 12%, the capitalization rate will be 12%, giving an investment value of 8.5 times the projected earnings of the small business.

(4) [1:135] **Capitalization of "excess" earnings method ("formula" approach):** A common method of appraising a going business is to first determine what portion of its earnings represent a fair return on the fair market value of its net *tangible* assets (i.e., adjusted net worth or invested capital), and then value its *intangible* assets (i.e., "goodwill") by capitalizing the remainder of the earnings. [See, e.g., Rev.Rul. 68-609, 1968-2 CB 327; *PhilipMorris Inc. & Consolidated Subsidiaries v. Commr.* (1991) 96 TC 606, aff'd without opn. (2nd Cir. 1992) 970 F2d 897]

(a) [1:136] **Example:** Assume XYZ Corporation has an income stream of $100,000, and the fair market value of its net tangible assets (fair market value of total assets less liabilities) is $500,000. If the percentage rate of return on tangible assets that prevails in XYZ's industry is 10% (or use 10% if no industry data is available), then $50,000 or half of XYZ's income represents a fair return thereon. The remaining ("excess") income of $50,000 represents a return on the intangible value of the business, for which a capitalization rate must be chosen in light of the business risks and other factors (*see* ¶ 1:129 ff.). Assuming a 25% capitalization rate (or an investment value of 4 times the "excess" earnings), the resulting value of the "goodwill" is $200,000, which is then added to the value of XYZ's net tangible assets of $500,000, to arrive at a $700,000 fair market value for the corporation.

(b) [1:137] **Comment:** This valuation method requires determining *two rates of return—one for tangible net worth, and one for "goodwill"*—when it is usually difficult enough to get one overall, reasonably accurate rate of capitalization for the earnings of a business. Nevertheless, its use has been approved in California. [See, e.g., *Community Develop. Comm'n v. Asaro* (1989) 212 CA3d 1297, 1305-1306, 261 CR 231, 235-236]

On the other hand, the IRS has criticized this method, stating that the "formula" approach "may be used in determining the fair market value of intangible assets of a business only if there is no better basis available for making the determination …" [Rev.Rul. 68-609, supra]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 1:A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 1. Preliminary Considerations

Forms

[Form 1:A] Engagement Letter

BROWN & GREEN LLP

Attorneys at Law

1010 Fifth Avenue

Central City, CA 99011

(Date)
Mr. Henry Host
234 Malcom Street
Central City, CA 99018
Mr. Charles Chef
1567 Gloria Avenue
Central City, CA 99018

Re: Organization of "Luminarias, Inc."

Gentlemen:

It was a pleasure meeting with you yesterday to discuss the organization of a new corporation to be known as "Luminarias, Inc." I was most impressed with your plans, and my law firm and I welcome the opportunity to assist you in achieving them.

This engagement letter is to confirm the terms upon which we undertake to counsel and assist you in connection with the organization and continued representation of your proposed venture, and to obtain your consent to our representing your multiple interests.

Services to be rendered: Brown & Green LLP will provide all legal services required in connection with the organization of the corporation under California law. Such services will include appropriate preincorporation planning with the two of you, preparation of necessary documentation and assistance with the formalities required to complete formation of the corporation, and the drafting of a buy-sell agreement between the two of you as shareholders. We will also provide guidance in connection with capitalization of the corporation, and in satisfying the requirements of Federal and State securities laws in issuing the corporation's securities.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(OPTIONAL) Services that will not be rendered: [Describe any areas where services/advice will not be given.]

Although I expect to handle most of this work myself, our firm necessarily must retain complete discretion in assigning the work within the firm.

(OPTIONAL) Authorization to incorporate: You hereby authorize Brown & Green LLP or our designees to serve as the sole incorporator or incorporators of the corporation you are retaining us to organize.

(OPTIONAL) Services of others: In the event we deem it necessary, we shall be authorized to employ on your behalf accountants, tax specialists and/or other specialists to assist us in planning and organizing the corporation. Their fees shall be payable by you in addition to the fees charged by our firm for our services.

(OPTIONAL) Communications to and from clients: Until either of you otherwise instructs us in writing, we shall be authorized to accept directions from either of you on behalf of both; and any communications by us to either of you at the above addresses shall be deemed received by you both.

Client responsibility: Each of you agrees to be responsible, jointly and severally, for our legal fees and for any costs or expenses advanced by us on your behalf, although the corporation may later reimburse you for such amounts or pay legal fees and costs on your behalf. Until formation of the corporation, we shall be representing you jointly. Thereafter, however, we will be representing the entity rather than either of you individually. We will take our instructions from the board of directors of the corporation or from the officers authorized by the board to act on behalf of the corporation.

Fees to be charged:

(OPTIONAL) Fixed fee with retainer: Our fee for these services will be one thousand five hundred dollars ($1,500). This fee shall be payable $1,000 upon signing this engagement letter, and the balance within 30 days following formation of the corporation, regardless of whether our services are then completed.

(OPTIONAL) Hourly fee with retainer: Our fee for these services will be billed on the basis of time expended and the hourly billing rates of the attorneys or paralegals involved. Our current billing rates, which are subject to future adjustment, range from $125 per hour for paralegals to $550 per hour for our most senior partners. We request a retainer of $2,500 as an initial payment against such fees. The retainer will be placed in the BROWN & GREEN LLP Client Trust Account, from which we will make disbursements into our firm account to cover amounts we will bill you under this engagement letter. We will send you a monthly statement of account for our fees, costs and reimbursable advances, showing the amounts charged against your retainer and the retainer balance. When your retainer deposit is depleted, you agree promptly to pay any further billings within 30 days of receipt.

Costs and expenses to be charged: You shall also be responsible for whatever expenses and costs we may reasonably incur in rendering our services, including, without limitation, filing fees, recording fees, franchise tax deposits, telephone charges, document copying costs, and travel expenses. We estimate such expenses will be approximately $1,000.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

It shall be your obligation to advance sufficient funds to us to cover such costs and expenses before we are required to pay or incur such expenses. However, we may, at our election, advance such funds on your behalf, in which event, it is your obligation to reimburse us immediately upon demand.

Finance charge for past due statements: We will tender statements for our professional services and related costs and disbursements at such intervals as we deem appropriate (usually monthly) unless a different arrangement is made with you. We expect that our statements will be paid forthwith and, in any event, within thirty (30) days after they are presented unless, of course, other arrangements have been made with you in advance. A finance charge, calculated at the rate of 0.833% per month (10% annual percentage rate) is added to delinquent accounts. The finance charge is assessed upon any portion of a monthly bill for which payment has not been received by the last day of the following month (i.e., approximately 30 days).

Potential conflicts of interest: Because your individual circumstances and objectives for this venture are not identical, it is our responsibility to point out the possibility that your respective interests may conflict in various matters involved in the organization and operation of the proposed corporation.

(OPTIONAL) Rule 1.7(a) of the California Rules of Professional Conduct governing attorneys generally provides that an attorney shall not, without informed written consent from each client, represent a client if the representation is directly adverse to another client.

Without limitation, and solely by way of example, we believe your interests may conflict in the following areas:

- Because our firm previously represented Mr. Host in connection with the dissolution of his marriage, we may have obtained confidential information regarding him which is legally privileged and cannot be disclosed to Mr. Chef. Such information may or may not be relevant to Mr. Chef's present dealings with Mr. Host.
- Because of differences in age between Mr. Host and Mr. Chef, it may be to Mr. Host's advantage to bargain for a mandatory buy-out provision in the shareholders' buy-sell agreement, while it may be to Mr. Chef's advantage to bargain for an optional buy-out. Also, Mr. Host may prefer to receive the purchase price for his shares in a lump sum, while Mr. Chef may prefer to have the payments spread out as long as possible.
- Because Mr. Host is preparing to transfer certain personal assets to the corporation in exchange for stock, your interests may conflict in connection with the valuation of the assets and the terms and characteristics of the stock to be issued in payment therefor.
- *(CONTINUE WITH ADDITIONAL AREAS OF POTENTIAL CONFLICT)*

If we are to represent you jointly, you must understand the risks involved:

- Instead of vigorously asserting either client's interest on an issue, we will likely attempt to balance your interests. This could lead to results less favorable than might obtain if you were represented separately.
- Joint representation may also result in loss of the attorney-client privilege and confidentiality among yourselves with respect to communications between you *(individually or jointly)* and members of this firm regarding this engagement.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- In the event a dispute arises between you, we will be precluded from representing either of you against the other (except if you jointly consent in writing to our doing so and such representation is not prohibited by the California Rules of Professional Conduct).

While we perceive no actual conflicts of interest between you at this time, we cannot undertake to represent you jointly unless assured that each of you understands the potential for conflicting interests and the risks involved therewith, as discussed above, and nonetheless consents in writing to our representing you jointly.

In this regard, we recommend that each of you consult independently with other counsel to review your personal objectives and to obtain independent legal advice concerning whether it is in your interests to consent to having our law firm represent you jointly.

(IF APPLICABLE) Professional liability insurance: Pursuant to Rule 1.4.2 of the California Rules of Professional Conduct, we are informing you that we do not have professional liability insurance.

(OPTIONAL) Arbitration of disputes: We seldom have disagreements with our clients concerning our services or fees, but some occasionally do occur. It is our desire to resolve any such disagreement through amicable discussion; unfortunately, such disputes cannot always be resolved in that way. Our experience is that in such instances it is in the interest of both the client and the firm that the dispute be resolved through binding arbitration, rather than by legal action in the courts. To that end you and we agree, subject to the provisions of the following paragraph, that any dispute between us regarding the services that we render under this engagement letter, including claims for negligence or professional malpractice, or the fees and costs that we charge for such services, which cannot be resolved in a reasonable time by discussions between us, shall be submitted to binding arbitration by _____, _____, California. By agreeing to binding arbitration, you and the firm waive the right to seek remedies in court, including the right to a jury trial, other than with respect to the enforcement of any arbitration award. You and the firm further agree that the prevailing party in such arbitration or any related court proceeding shall be awarded the reasonable costs and attorneys fees incurred in connection with the dispute. Any arbitration award will be binding and enforceable in any court with appropriate jurisdiction.

Beginning in Section 6200 of the California Business and Professions Code, California has established an alternative procedure for arbitrating disputes between lawyer and client over the fees and costs charged by a lawyer. We shall notify you of this alternative, if it is applicable, before the firm initiates any arbitration to resolve a dispute over fees and costs. In the event that you elect not to pursue the alternative arbitration procedure provided by the Business and Professions Code, or in the event that you elect to pursue this alternative and either of us rejects any arbitration award made under this alternative procedure, then you and the firm agree to submit the dispute over fees and costs to binding arbitration by _____, as agreed to in the preceding paragraph. In all events, any dispute between us concerning claims for negligence or professional malpractice shall be resolved by arbitration before _____, as outlined above, and not before the alternative procedure provided by the Business and Professions Code.

In regard to such arbitration, we advise you that:

- you are waiving your right to a jury trial and to seek remedies available in court proceedings;
- prearbitration discovery is generally more limited than and different from court proceedings;
- arbitration costs may have to be paid prior to the commencement of arbitration and may be substantially greater than court costs;

• the arbitrator's award is not required to include factual findings or legal reasoning; and

• your right to appeal or to seek modification of the arbitration award is strictly limited and the award is final and binding.

YOUR INITIALS HERE SIGNIFY ACKNOWLEDGMENT OF THIS EXPLANATION	___________ *(client initials)*	___________ *(client initials)*

Termination of services: You have the right at any time to terminate our services upon written notice to us, and we shall immediately after receiving such notice cease to render additional services. Should you elect to exercise such right, we shall cooperate with you in facilitating the orderly transfer of your files and records to you or to your new attorneys. Such termination shall not, however, relieve you of your obligation to pay the fees due for services rendered and disbursements incurred prior to such termination.

If you should fail to meet your obligations hereunder and shall continue to fail to do so for ten (10) or more days after written notice thereof from us, or if, by reason of actions taken by you, we conclude that our capacity to represent you has been materially impaired, then we shall have the right to decline to represent you further. Should we elect to exercise this right, you agree to cooperate in the execution and delivery of a substitution of attorneys in any court or administrative proceeding. This right is in addition to those created by statute or recognized by the rules of professional conduct which govern lawyers.

Return of records: After our services under this engagement letter conclude, we will, upon your request, deliver the files we maintain and compile hereunder to you or to your designee (other than attorney work product, which we shall retain). If you do not request the files we maintain and compile under this engagement letter, then we shall retain them for a period of two (2) years after the matter is closed. If you do not request delivery of the files before the end of the two-year period, then we shall have no further obligation to maintain the files and may, in our sole discretion, destroy them without further notice to you.

Attendance at judicial or other proceedings: Occasionally our attorneys may be called upon or required to participate in judicial, administrative, or alternative dispute resolution proceedings, not as legal counsel, but on behalf of a client as a fact or expert witness. If you require our appearance in any such proceeding (other than one involving a dispute with you over our fees or services), then you agree to pay our fees and costs as provided in this engagement letter, in connection with any such appearance, at our then prevailing rates. Such fees and costs may include time reasonably required for preparation, travel time, waiting time in court or elsewhere, and time in depositions and other discovery proceedings, as well as disbursements as provided above.

Should you have any questions regarding anything stated herein, please contact me before signing and returning the enclosed copy of this engagement letter.

Sincerely,
BROWN & GREEN LLP
By ___________
George Green
CLIENT AUTHORIZATION AND CONSENT:

We agree to the terms and conditions of this engagement letter, and specifically consent to BROWN & GREEN LLP representing us jointly notwithstanding the potential conflicts of interest between us, as outlined in this engagement letter. We understand that we have the right, and have been advised, to seek independent counsel before signing this authorization and consent.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

DATED:___________

____
Henry Host

____
Charles Chef

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 1:B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations

Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 1. Preliminary Considerations

Forms

[Form 1:B] Checklist for Initial Client Interview

Comment: Many attorneys find it helpful to use a checklist of relevant questions during the client interview and follow-up period. A reliable checklist can serve as a reminder of the various business/tax/legal considerations that may apply in choosing and organizing the appropriate business entity.

Of course, any checklist has its limitations and should not be followed slavishly. In particular circumstances, a different order of inquiry may be appropriate, and various sections of the checklist may be irrelevant or duplicative of information already elicited. In addition, a checklist is not always complete enough to obtain all of the information that may be necessary to arrive at appropriate advice.

With these qualifications, the following checklist may be found helpful in interviewing clients regarding a proposed business venture:

A. GENERAL INFORMATION ABOUT PROPOSED FINANCIAL AND MANAGEMENT PARTICIPATION

1. Who are the participants in the business?

Name	Address	Age	Marital Status	FinCEN No.

2. What is each contributing financially to the business?

a. Cash? _____ Amount? _____ _____ _____

b. Other property?

- description: ___________

- agreed value? $________ $________

c. Services?

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- previously rendered? _____ agreed value? _____

- future services? _____ agreed value? _____

d. Commitment to make future payments? _____ Amount(s)? _____

3. What is it expected each will receive from the business in consideration of such contribution?

a. A share in ownership of the business' assets?

- what share (____%)?

b. A share in profits?

- what share basis (____%)?

- any conditions?

c. Debt?

- amount? $________ $________

- terms of repayment (interest rate, maturity, etc.)

- to be secured? _____ by what business assets? _____

4. How will each principal participate in management of the business?

a. By virtue of ownership interests only?

b. As management employee?

c. Will any principal not participate in management?

5. How will management control be allocated among participants?

a. In proportion to investment (respective ownership interests)?

b. Other allocation?

c. Does any participant wish veto power over particular business decisions? If so, what kind of decisions?

6. Is centralized management important (e.g., where participants are numerous but management authority is to be given to a designated few)?

7. Will the corporation be exempt from FinCEN beneficial ownership information (BOI) reporting under the Corporate Transparency Act (CTA)?

8. If the corporation will not be exempt from FinCEN BOI reporting, who will be a “beneficial owner” for FinCEN reporting purposes (i.e., persons with ownership or control of the corporation)?

B. INFORMATION RELATING TO TAX FACTORS

1. Is the business expected to operate at a profit or a loss in the near future?

a. What are the estimated profits (losses)?

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

—	first year	$________
—	second year	$________
—	third year	$________
—	subsequent	$________

b. If profits expected, do the owners plan to withdraw most of them currently or allow them to accumulate?

— Will profits accumulate in excess of $250,000 ($150,000 if a professional corporation)?

c. If losses are expected, do owners have other income against such losses?

How would their individual taxes be reduced by deducting such losses?

—	owners' other taxable income	$________
—	appropriate tax rate	____%
—	share of estimated losses	$________
—	approximate tax savings	$________

2. Are fringe benefits important to the participants?

a. Do they wish to make tax-deductible contributions from business income for retirement plans?

b. Are other employee benefits important, such as group life, medical, disability insurance; employee "incentive stock options"; benefits obtainable through VEBAs?

3. If other considerations favor incorporation, would the venture be eligible for Subchapter S status?

a. Will there be a single class of ownership interests—i.e., all common stock? (Distinction as to voting rights permitted.)

b. No more than 100 shareholders?

c. Meet other requirements?

C. INFORMATION RELATING TO NONTAX FACTORS

1. Is limited liability important to the owners?

a. Do they have personal assets they wish to insulate from the business risks?

b. Will the business involve substantial risk of liabilities?

- tort claims? (e.g., product liability)

- to what extent is insurance available?

c. Will the parties be required to furnish their personal guarantees to obtain credit for the business?

d. Do they object to each being bound by, and liable for, the acts of the others?

e. Are they able and willing to adequately capitalize the business to meet its reasonably foreseeable needs?

f. Will they observe the formalities of dealing with the business as a separate entity?

2. What is the expected duration of the venture?

a. Would the parties wish to continue the business if one of them died, retired or withdrew?

3. Is transferability of interests important?

a. Do the parties wish to restrict the transfer of their interests to others?

- what restrictions?

- in what events?

b. Will other owners be added in the near future?

4. Is anonymity important?

5. Are the differences in formation (and subsequent) costs a significant factor?

D. INFORMATION FOR INCORPORATION

1. Name of corporation: ___________

2. Address of principal office: ___________

3. Corporate purpose:

□ General □ Professional Practice

4. Name(s) of incorporator(s): ________________..

5. Number of directors authorized: ....

6. Names and addresses of initial directors:

____

a. To be included in articles (vs. subsequent written designation by incorporator(s))? ....

7. Name and address of initial agent for service of process:

____

8. Names and address of initial officers:

Chairperson of board: ________..

President: ________..

Vice-President(s): ________________________..

Chief Financial Officer (Treasurer): ________ ....

Asst. Treasurer: ________ ....

Secretary: ________ ....

Asst. Secretary: ________ ....

9.
Executive Compensation Arrangements: ________________ ....

a.
Stock option plan? ....

b.
Stock purchase plan? ....

10. Authorized Capital:

_____ shares common stock

_____ shares preferred stock, having:

□ dividend priority: _____ cum./non cum.

□ liquidation priority: _____

□ conversion rights: _____

□ participation rights: _____

voting rights: ....
redeemable: ....
other: ....

11. Initial Shareholders:

Name/Address	FinCEN No.	# of shs.	Class	Consideration to be paid	Agreed value

12. Share issuance exemption under federal and state securities laws:

Federal exemption under:

_____ Rule 147/147A
_____ Rule 504
_____ Rule 506
_____ Crowdfunding
Other: _____

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

California exemption under: _____ § 25012(f)
_____ § 25102(h)
Other: _____

13. If a going business is to be incorporated:

Predecessor's accounting method: ....

Assets being transferred to corporation: ________...

Bulk sales escrow required? ....

Will transfer result in recapture of accelerated depreciation or investment tax credits? ....

Is tax-free exchange under IRC § 351 desired (for noncash assets transferred to corporation)? ....

14. Shares are to be held subject to:

_____ Buy-sell agreement, following terms: ________________________...

_____ Voting trust agreement: ________...

_____ Shareholder voting (pooling) agreement: ________...

_____ Voting proxy in favor of: ....

15. Will corporation be a statutory close corporation? _____ If so,

a.
Any change in voting rights from those conferred by share ownership? ....

b.
Any change in dividend rights from those conferred by share ownership? ....

c.
Any change in asset distribution or other economic rights from those conferred by share ownership? ________..........................

d.
Any other arrangements varying or eliminating statutory standards? ________________..

16.
Any special provisions regarding corporate governance required in articles (e.g., preemptive rights, supermajority quorum and/or voting provisions for director or shareholder action, etc.)? ________________________..

17.

Include articles provision limiting directors' liability; authorizing additional indemnification of agents? ________......................

18.
Date and time of annual shareholders meeting: ________..

19.
Dates and times of regular meetings of board of directors: ________________..

20.
Corporation's fiscal year: ....

21.
Will corporation make a Subchapter S election? ....

If so, who will prepare and file? ....

22. Bank account at:

Bank: ....

Branch: ....

Acct. # (when known): ....

# of signatures: ....

Whose signature(s): ....

23. Name and address of corporate accountant:

____

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. ¶ 2:1

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 2. Substantive Law Considerations in Choosing Business Entity: Tax and Nontax Factors

[2:1] Lawyer's Role:

During the initial client interview, counsel will have learned from the clients their basic objectives and concerns regarding the proposed business venture. It is then up to the attorney to advise the clients of the various alternatives available to them, and to make recommendations if requested to do so.

While clients may come into the office saying they want to "set up a corporation" or "start a partnership" or "form a limited liability company," it is nevertheless the lawyer's responsibility to make sure they understand the tax and nontax ramifications of their choice, and the alternatives available to them.

Thus, counsel has to help the clients determine which form of business entity best fits the management and capital structure they desire in light of the clients' particular circumstances and the various tax and nontax considerations affecting the choice of entity.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. ¶ 2:1.1

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 2. Substantive Law Considerations in Choosing Business Entity: Tax and Nontax Factors

[2:1.1] Subsequent Conversion to Another Entity:

When selecting the most suitable form of business entity for clients at the outset of their venture, counsel should keep in mind —and advise the clients—that there are streamlined statutory procedures for *subsequent conversion* to another form of entity should that be warranted by future circumstances (e.g., converting a partnership or limited liability company into a corporation, or vice-versa). *See detailed discussion at ¶ 8:451 ff.*

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 2-A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 2. Substantive Law Considerations in Choosing Business Entity: Tax and Nontax Factors

---

A. Forms of Business Entities—Basic Characteristics

- 1. [2:3] Sole Proprietorship
  - a. [2:4] Unlimited personal liability for losses
  - b. [2:6] Management
  - c. [2:7] No formalities
    - (1) [2:8] Fictitious business name statute
  - d. [2:9] Transferability; duration
- 2. [2:10] General Partnership
  - a. [2:11] Characteristics
  - b. [2:13] Sharing profits
  - c. [2:14] Unlimited personal liability for losses
    - (1) [2:15] Liability for copartner's debts
    - (2) [2:16] Liability for copartner's wrongdoing
    - (3) [2:17] Not affected by agreement among partners
    - (4) [2:17.1] Exception—registered limited liability partnership
  - d. [2:18] Management and control
    - (1) [2:18.1] No right to compensation
  - e. [2:19] Fiduciary duties within partnership
    - (1) [2:19.1] Compare—corporate shareholders, officers and directors
  - f. [2:20] Transferability
    - (1) [2:20.1] Interest acquired by creditor
    - (2) [2:20.2] Comment re partner-imposed transfer restrictions
  - g. [2:21] Duration
    - (1) [2:21a] Dissolution
      - (a) [2:21b] Mandatory buy-out
        - 1) [2:21c] Buy-out price
    - (2) [2:21.1] Compare—termination for tax purposes
  - h. Formation not dependent on particular formalities
    - (1) [2:22] Written agreement not required
    - (2) [2:22.1] Caution—compliance with fictitious business name statute
  - i. [2:22.5] Joint ventures as partnerships
  - j. [2:22.10] Compare—limited liability partnership
- 3. [2:23] Limited Partnership

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- a. [2:24.1] General partners' liability
  - (1) [2:24.2] Limitation on liability to limited partners
- b. [2:25] Limited partners as passive investors
  - (1) [2:26] Right to information, accounting
  - (2) [2:27] Participation in management as creating risk of personal liability for partnership debts
    - (a) [2:27.1] Activities *not* constituting participation in management
- c. [2:28] Class division of partnership interests
- d. [2:29] Consideration for partnership interest
  - (1) [2:29.1] Compare—limitations on consideration for corporate shares
- e. [2:31] Economic interest of limited partners
  - (1) [2:32] Share of profits, losses, distributions
  - (2) [2:33] Transfer of interest
- f. [2:33.1] Corporation (or LLC) as general partner
- g. [2:34] Formalities required—certificate of limited partnership
  - (1) [2:34.1] Contents
  - (2) [2:34.2] Recordation not required
  - (3) [2:34.3] Compare—optional written agreement
- h. [2:35] Duration
  - (1) [2:35.1] Compare—limited partner's death, incompetency, etc.

4. [2:36] Limited Liability Company (LLC)
- a. [2:36.1] Only one member required
- b. [2:36.2] Separate legal entity
- c. [2:36.3] Limited liability of members
  - (1) Exceptions
    - (a) [2:36.4] Guarantor liability
    - (b) [2:36.5] “Alter ego” liability
- d. [2:36.10] Centralized management optional
  - (1) [2:36.11] LLCs without centralized management (“member-managed”)
    - (a) [2:36.11a] No right to compensation
    - (b) [2:36.12] Voting interest ordinarily corresponds to interest in profits
      - 1) [2:36.13] Unanimous vote requirement
    - (c) [2:36.14] Each member can bind LLC
      - 1) [2:36.15] Compare—general partner's personal liability
  - (2) [2:36.16] LLCs having designated managers (“manager-managed”)
    - (a) [2:36.17] Managers' liability
    - (b) [2:36.18] Designation of “board of managers”
      - 1) [2:36.18a] Designation of “board of directors”?
  - (3) [2:36.19] Fiduciary duties to LLC and members
- e. [2:36.20] New members
  - (1) [2:36.21] Economic interests assignable
- f. [2:36.22] Duration
- g. [2:36.26] Member's contribution
  - (1) [2:36.28] Compare—shareholder's contribution for corporate shares
- h. [2:36.29] Share of profits, losses, distributions
- i. Required formalities
  - (1) [2:36.30] Articles of organization
    - (a) [2:36.31] Contents of articles
  - (2) [2:36.32] Written or oral operating agreement
- j. [2:36.36] Limitation—not available to most “professionals”

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [2:36.37] Businesses authorized to operate as LLC
(2) [2:36.38] "Nonprofessional, occupational services" distinguished
(3) [2:36.39] Compare—limited liability partnership (accountants, architects, lawyers, engineers and land surveyors)
5. Corporation
a. [2:37] Separate legal entity status, generally
(1) [2:37.1] Broad range of powers
(2) Limitations
(a) [2:37.2] Generally cannot appear in court in "pro per"
1) [2:37.2a] Opportunity to retain counsel
2) [2:37.2b] No shareholder intervention on corporation's behalf
3) [2:37.2c] Attorney's withdrawal conditioned upon warning against pro se representation
4) Exceptions
a) [2:37.3] Small claims suit
b) [2:37.3a] Administrative proceedings
5) [2:37.3b] Compare—other entities
(b) [2:37.3c] Cannot proceed "in forma pauperis"
b. [2:38] Liability for corporate debts
(1) [2:39] Distinguish—liability as guarantor, "alter ego" or culpable tortfeasor
c. [2:40] Management and control
(1) [2:41] The same persons may be…
d. [2:42] Formalities
e. [2:43] Duration
f. [2:43.1] Constitutional protections
(1) [2:43.2] Not "citizens" within privileges and immunities clause
(2) [2:43.3] Right to due process and equal protection
(3) [2:43.3a] Freedom of speech
(4) [2:43.3b] Right to counsel
(5) [2:43.4] No privilege against self-incrimination
(a) [2:43.4a] No officer's or director's "derivative" privilege
1) [2:43.4b] Distinguish—testimony re records' *location*
(b) [2:43.4c] No privilege for former officers/directors
(c) [2:43.4d] Compare—sole proprietorships
(6) [2:43.5] Limited right to privacy
(a) [2:43.6] Privacy right under California Constitution?
(b) [2:43.7] Common law privacy right?
1) [2:43.8] Civil litigation discovery
(c) [2:43.11] No corporate privacy right under federal Freedom of Information Act

[2:2] The most common forms for carrying on a business are:

• Sole proprietorship;

• General partnership;

• Limited liability partnership (available only to accountants, attorneys, architects, engineers and land surveyors);

• Limited partnership;

• Limited liability company;

• Corporation (including various kinds of corporations—statutory close corporations, professional corporations, S corporations, social purpose corporations and benefit corporations).

1. [2:3] **Sole Proprietorship:** This is the simplest form in which to conduct a business. A sole proprietorship is *not* a legal entity itself. Rather, the term refers to a natural person who *directly* owns the business and is directly responsible for its debts.

a. [2:4] **Unlimited personal liability for losses:** While all profits belong to the business owner, so do all losses. Thus, if the business is unprofitable, or other liabilities are incurred, the owner (sole proprietor) is personally liable therefor (i.e., all the owner's personal assets and wealth are at risk in a proprietorship).

[2:5] Moreover, an owner who is married (or in a registered domestic partnership) puts the *community property* at risk: Community property is liable for the contract obligations of either spouse (or registered domestic partner) incurred during the marriage (or domestic partnership). [Fam.C. §§ 910(a), 297.5]

b. [2:6] **Management:** The business owner (sole proprietor) has total management authority, but may act through agents or employees. (Their acts may increase the risk of personal liability, under agency and respondeat superior principles.)

c. [2:7] **No formalities:** No formalities are required to engage in business as a sole proprietor (other than complying with any applicable licensing requirements).

(1) [2:8] **Fictitious business name statute:** If the business is conducted under a name that does *not* include the owner's surname, or implies the existence of additional owners, the owner is required to file the certificate and publish the notice provided in Bus. & Prof.C. § 17900 et seq. (The only consequence of failing to do so, however, is that the owner is barred from maintaining legal action to enforce an obligation owing to the business until the certificate is filed.) [See Bus. & Prof.C. §§ 17910, 17913 (amended Stats. 2023, Ch. 20; eff. 1/1/24), 17918; *Templeton Action Committee v. County of San Luis Obispo* (2014) 228 CA4th 427, 432, 175 CR3d 346, 349-350]

Doing business under a fictitious business name does not create a separate legal entity. [*Rossdale Group, LLC v. Walton* (2017) 12 CA5th 936, 940, 219 CR3d 605, 607; *Cleveland v. Johnson* (2012) 209 CA4th 1315, 1330, 147 CR3d 772, 784]

• ***FORM:*** The statutory form of the Fictitious Business Name Statement was updated effective January 1, 2024 to delete obsolete references and make other technical, nonsubstantive changes (e.g., requiring business mailing address rather than residence address) (see Bus. & Prof.C. § 17913 (amended Stats. 2023, Ch. 20; eff. 1/1/24)). The Fictitious Business Name Statement form used by the City and County of San Francisco is representative. It is available online at the County Clerk's website (*https://sfgov.org/countyclerk*).

d. [2:9] **Transferability; duration:** The owner can sell the business as the owner chooses. Its duration is limited only by the owner's willingness or ability to stay in business.

2. [2:10] **General Partnership:** A general partnership is a form of business entity in which two or more co-owners engage in business for profit. [Corps.C. § 16202(a); see *Corrales v. Corrales* (2011) 198 CA4th 221, 223-224, 227, 129 CR3d 428, 429, 432—one "partner" cannot operate in partnership form after departure of other partner (*discussed further at* ¶ *2:21a*)]

So long as the parties have jointly agreed to carry on a business for profit, they are general partners even though they have no specific intent to be "general partners" or have not reached agreement on how to share profits or losses. [*Holmes v. Lerner* (1999) 74 CA4th 442, 453-458, 88 CR2d 130, 137-142 (interpreting and applying predecessor to Corps.C. § 16202(a)); see *Eng v. Brown* (2018) 21 CA5th 675, 694, 230 CR3d 771, 788; *and* ¶ *2:22; ;* compare *Marriage of Geraci* (2006) 144 CA4th 1278, 1292-1293, 51 CR3d 234, 244-246—husband's filing fictitious business statement without wife's knowledge, falsely showing her as partner, did not create partnership]

a. [2:11] **Characteristics:** A general partnership has *some* of the attributes of a separate legal entity:

• It can hold and convey legal *title to real property* in its own name (rather than in the names of the partners). [Corps.C. §§ 16204, 16302(a)(1)]

• It can *sue and be sued* in the partnership name. [CCP § 369.5(a); Corps.C. § 16307(a)]

• It continues in existence notwithstanding the "dissociation" of one or more partners (but "dissociation" may trigger buy-out rights; *see* ¶ *2:21b ff.*). [See Corps.C. §§ 16701-16705]

[2:12] But in most other important respects, a general partnership is simply a form of co-ownership by several persons; i.e., the partners together own the business assets and (except in a limited liability partnership, *¶ 2:310 ff.*) are personally liable for all business debts. [Corps.C. § 16306(a)]

b. [2:13] **Sharing profits:** The partnership agreement normally provides how profits are to be split. The agreement may allocate profits and losses *disproportionately* (e.g., profits may be shared equally while losses are allocated entirely to those investing funds). In the absence of agreement, profits are shared equally. [Corps.C. § 16401(b)]

c. [2:14] **Unlimited personal liability for losses:** Except in a "limited liability partnership" (*see* ¶ *2:17.1, 2:314*), each general partner puts all their personal resources at risk for debts and obligations of the partnership business: Each is *jointly and severally* liable to the partnership creditors. [Corps.C. § 16306(a)]

(1) [2:15] **Liability for copartner's debts:** The risk of personal liability is enhanced by the fact each general partner is deemed the *agent* of the partnership in dealings with third persons, as long as such copartner was apparently carrying on partnership business "in the ordinary course." (Conversely, pursuant to agency law, one copartner cannot bind the others where the copartner has *no authority* to act in a particular manner on behalf of the partnership and the third person with whom the copartner was dealing knew or had received notice of the lack of authority.) [Corps.C. § 16301(1); see *In re Mediscan Research, Ltd.* (9th Cir. 1991) 940 F2d 558, 563]

(2) [2:16] **Liability for copartner's wrongdoing:** Further, each partner may be *jointly and severally* liable for tortious acts committed by a copartner in the ordinary course of partnership business or with partnership authority, including misapplication of another's money or property. [Corps.C. §§ 16305, 16306; see *Miske v. Bisno* (2012) 204 CA4th 1249, 1256-1258, 139 CR3d 626, 631-633]

(3) [2:17] **Not affected by agreement among partners:** While the partners may agree among themselves to share losses or pay debts in differing proportions, third persons are *not* bound by such agreements. A partnership creditor is entitled to recover in full from any one or more of the partners. (Such partner(s) would then be entitled to contribution or indemnification from the others in accordance with their agreement; or, absent such agreement, in accordance with their respective shares in partnership profits.) [Corps.C. § 16401(b), (c); see *Wall v. Siegel* (1998) 62 CA4th 875, 879, 73 CR2d 102, 104 (decided under prior law)]

(4) [2:17.1] **Exception—registered limited liability partnership:** Accountants, attorneys, architects, engineers and land surveyors can avoid personal liability for partnership debts (other than for the respective partner's own malpractice or other tortious misconduct) by registering as a limited liability partnership; *see ¶ 2:310 ff.* [Corps.C. §§ 16101(a)(8)(A), 16306(c)]

d. [2:18] **Management and control:** As co-owners, each general partner has equal rights to participate in the management and control of the business. Disagreements as to matters in the *ordinary course* of partnership business are decided by a *majority* of the partners. Disagreements over *extraordinary* matters and amendments to the partnership agreement require consent of *all* partners. (Of course, the partnership agreement may vary these "default" rules.) [Corps.C. §§ 16103(a), 16401(f), (j)]

(1) [2:18.1] **No right to compensation:** No partner has the right to receive compensation for services performed in the ordinary course of partnership business unless the partners agree otherwise by written agreement or conduct. (But a partner is entitled to reasonable compensation for services rendered in winding up the partnership's business.) [Corps.C. § 16401(h); *Broffman v. Newman* (1989) 213 CA3d 252, 260, 261 CR 532, 538—limited partner's silence when informed of proposal to pay compensation to general partner for management services deemed implied consent]

e. [2:19] **Fiduciary duties within partnership:** Partners are obligated to carry out the enterprise with the highest good faith toward each other and, in particular, assume fiduciary duties of *due care* and *loyalty* to the partnership *and each other* in regard to partnership operations. These duties, which include prohibitions against self-dealing and conflicts of interest, must be discharged consistently with the obligations of good faith and fair dealing. "Partnership is a fiduciary relationship, and partners are held to the standards and duties of a trustee in their dealings with each other." [See Corps.C. §§ 16103(b)(3)-(5), 16404; *Agam v. Gavra* (2015) 236 CA4th 91, 112-113, 186 CR3d 295, 312; *Pellegrini v. Weiss* (2008) 165 CA4th 515, 524-525, 81 CR3d 387, 397; *Enea v. Sup.Ct. (3-D)* (2005) 132 CA4th 1559, 1564-1568, 34 CR3d 513, 516-519]

(1) [2:19.1] **Compare—corporate shareholders, officers and directors:** In contrast, *shareholders* (other than controlling shareholders) do *not* owe fiduciary duties to other shareholders (unless they agree to act as copartners or coventurers or otherwise assume fiduciary obligations). [See *Persson v. Smart Inventions, Inc.* (2005) 125 CA4th 1141, 1156-1159, 23 CR3d 335, 346-349—partners' fiduciary obligations to each other ceased upon completion of corporate formation and

issuance of stock in exchange for partnership interests; *Eng v. Brown* (2018) 21 CA5th 675, 694-698, 230 CR3d 771, 788-791; *Miles, Inc. v. Scripps Clinic & Research Found.* (SD CA 1993) 810 F.Supp. 1091, 1099]

On the other hand, corporate *officers* and *directors* have fiduciary duties of due care and loyalty to the *corporation* and *its shareholders collectively* (*see* ¶ *6:281 ff.*, *6:243 ff., 6:285 ff.*). And *controlling shareholders* have fiduciary duties to exercise their corporate influence fairly for the benefit of the *corporation* and the *other shareholders* (*see* ¶ *6:335 ff.*).

f. [2:20] **Transferability:** Unless otherwise provided by agreement, no one can become a member of the partnership without the consent of all existing partners. [Corps.C. § 16401(i)]

But a partner may *assign* their share of the profits and losses and right to receive distributions (a partner's "transferable interest"). [Corps.C. §§ 16502, 16503(a)] And a partner's judgment creditor may obtain an order charging the partner's "transferable interest" to satisfy the judgment (and may also obtain any other appropriate orders, including appointment of a receiver). [Corps.C. § 16504]

(1) [2:20.1] **Interest acquired by creditor:** A foreclosing judgment creditor acquires only the debtor partner's *interest in the partnership*—i.e., the debtor partner's *share of partnership profits and surplus*. The purchaser obtains *no* right to specific partnership property or to participate in managing the partnership business. [See Corps.C. §§ 16503, 16504; *Hellman v. Anderson* (1991) 233 CA3d 840, 846, 852, 284 CR 830, 834, 838]

(2) [2:20.2] **Comment re partner-imposed transfer restrictions:** Sales pursuant to Corps.C. § 16504 may be complicated by partnership agreements containing rights of first refusal or restrictions on the transfer of partnership interests. Dictum in one case suggested that such agreements may not divest the court of power to order an execution sale; but the case did not decide the issue because the sale did not violate the agreement in question. [*Crocker Nat'l Bank v. Perroton* (1989) 208 CA3d 1, 10, 255 CR 794, 799 (decided under prior law)]

g. [2:21] **Duration:** A partnership does not have a reliable continuity of existence in comparison to a corporation.

(1) [2:21a] **Dissolution:** A partnership *at will* is dissolved by the "express will to dissolve" of *at least half* of the partners. [Corps.C. § 16801(1); see *Corrales v. Corrales* (2011) 198 CA4th 221, 223-224, 227, 129 CR3d 428, 429, 432—2-person partnership automatically dissolved upon 1 partner's withdrawal (¶ *2:10*)]

A partnership *for a definite term or particular undertaking* is dissolved before expiration of the term or completion of the undertaking (a) by the express will of *all* partners or (b) after 90 days following a partner's death, bankruptcy or "wrongful dissociation" (voluntary withdrawal in breach of partnership agreement, judicial expulsion for breach of duty or wrongful conduct, etc.; see Corps.C. § 16602(b)), *unless* within that time a majority *in interest* of the partners agree to continue the partnership. [Corps.C. §§ 16601(6)-(10), 16801(2)]

Other grounds for dissolution are set forth in Corps.C. §§ 16801(3)-(6), and generally include events that make continuation of the partnership unlawful or impracticable. [See, e.g., *Navarro v. Perron* (2004) 122 CA4th 797, 801-802, 19 CR3d 198, 200-201]

(a) [2:21b] **Mandatory buy-out:** Events of dissociation that do *not* cause dissolution (e.g., an event set forth in the partnership agreement as causing the partner's dissociation) nevertheless trigger a mandatory buy-out. [Corps.C. §§ 16601, 16602, 16701]

1) [2:21c] **Buy-out price:** If the partnership agreement does not determine the buy-out price, the price is the amount that would have been distributable to the dissociating partner if the partnership were dissolved and its assets sold for the *greater* of (i) liquidation value or (ii) value based on a sale of the entire business as a going concern (less offset for any damages resulting from a "wrongful dissociation"). [Corps.C. § 16701(b), (c); see *Rappaport v. Gelfand* (2011) 197 CA4th 1213, 1224-1229, 129 CR3d 670, 677-681]

A partner who wrongfully dissociates from a partnership having a definite term or particular undertaking is not entitled to payment until expiration of the term or completion of the undertaking (unless the partner can show to the court that earlier payment will not cause undue hardship to the partnership business). [Corps.C. § 16701(h)]

(2) [2:21.1] **Compare—termination for tax purposes:** For tax purposes, a partnership terminates if no part of its business is carried on by any partner. [IRC § 708(b)(1)]

h. Formation not dependent on particular formalities

(1) [2:22] **Written agreement not required:** No special formalities are required to form a general partnership; it may even be predicated on an *oral* agreement. [See Corps.C. § 16101(a)(10); *Weiner v. Fleischman* (1991) 54 C3d 476, 483-486,

286 CR 40, 43-45—oral joint venture or partnership agreement provable under "preponderance of evidence" (*not* higher "clear and convincing evidence") standard of proof; *Eng v. Brown* (2018) 21 CA5th 675, 694, 230 CR3d 771, 788; *Holmes v. Lerner* (1999) 74 CA4th 442, 453-458, 88 CR2d 130, 137-142 (*discussed at ¶ 2:10*)]

(2) [2:22.1] **Caution—compliance with fictitious business name statute:** A partnership (other than a limited liability partnership) whose name does not include the name of each general partner (or whose name suggests the existence of additional owners) must comply with the *fictitious business name statute*. [Bus. & Prof.C. § 17900 et seq.; *see ¶ 2:8*]

(A limited liability partnership need not comply with the fictitious business name statute, but must include "LLP" or another acceptable LLP designation as the last words or letters of its name; see Corps.C. §§ 16952, 16961.)

[2:22.2 - 2:22.4] ***Reserved.***

i. [2:22.5] **Joint ventures as partnerships:** A joint venture is a general partnership, but is typically a business formed to undertake a particular transaction or project rather than one intended to continue indefinitely. Joint ventures are commonly used in real estate matters where, e.g., two or more persons or entities form a joint venture to develop a specific parcel of property. [See *Chambers v. Kay* (2002) 29 C4th 142, 151, 126 CR2d 536, 544; *Weiner v. Fleischman* (1991) 54 C3d 476, 482, 286 CR 40, 43; *Cochrum v. Costa Victoria Healthcare, LLC* (2018) 25 CA5th 1034, 1053, 236 CR3d 457, 472; *Pellegrini v. Weiss* (2008) 165 CA4th 515, 524-525, 81 CR3d 387, 397—joint venturers' rights and liabilities between themselves governed by same rules that apply to partnerships]

The closest California *codification* of a "joint venture-like" entity is a "partnership for a definite term or particular undertaking." This differs from a "partnership at will" (all other general partnerships) in only minor respects. Most notably, dissolution of a partnership for a definite term or particular undertaking requires the assent of *all* partners, while a partnership at will may be dissolved if only half the partners so desire (*¶ 2:21a*). [Corps.C. § 16801(1) & (2)(B)]

[2:22.6 - 2:22.9] ***Reserved.***

j. [2:22.10] **Compare—limited liability partnership:** Accountants, attorneys, architects, engineers and land surveyors may operate as a "limited liability partnership" (LLP), which is a hybrid form of general partnership. The principals can all participate in management (as in a general partnership) and yet still enjoy limited liability (as in a limited partnership) and partnership pass-through tax treatment. LLPs are discussed separately at ¶ 2:310 ff.

Cross-refer: For a comprehensive treatment of general partnerships and joint ventures, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 3.

3. [2:23] **Limited Partnership:** A limited partnership is comprised of one or more "general" partners who manage the business and who are personally liable for partnership debts, and one or more "limited" partners who contribute capital and share in the profits, but who normally take no part in running the business and who incur no liability with respect to partnership obligations beyond their capital contributions. [See Corps.C. §§ 15903.02, 15903.03, 15904.02, 15904.04, 15904.06; see also *Jay v. Mahaffey* (2013) 218 CA4th 1522, 1541, 161 CR3d 700, 714-715]

The purpose of this form of business entity is to encourage *passive investors* to invest in the enterprise, allowing them to reap a share of the profits if it succeeds, but without risking more than their capital contributions. [*Evans v. Galardi* (1976) 16 C3d 300, 306, 128 CR 25, 30; *Sacramento Suncreek Apts., LLC v. Cambridge Advantaged Properties II, L.P.* (2010) 187 CA4th 1, 12-13, 113 CR3d 661, 669]

[2:24] *Caution—current vs. prior law:* The paragraphs below (¶ 2:24.1 ff.) discuss the Uniform Limited Partnership Act of 2008 (Corps.C. §§ 15900-15912.07) which, with certain exceptions, now governs *all* California limited partnerships. (Limited partnerships formed between 1984 and 2008 were governed by the California Revised Limited Partnership Act (repealed Corps.C. §§ 15611-15723), and pre-1984 limited partnerships were governed largely by the old Uniform Limited Partnership Act (repealed Corps.C. §§ 15501-15532).)

a. [2:24.1] **General partners' liability:** Except as otherwise provided by law or agreement, the general partners of a limited partnership are subject to the same liabilities as partners of a general partnership: i.e., joint and several liability for all debts and obligations of the partnership (¶ 2:14). [Corps.C. § 15904.04(a)]

Moreover, every general partner is an *agent* of the limited partnership. Thus, the partner's acts may bind the partnership when taken for apparently carrying on the activities of the limited partnership in the ordinary course of business. [Corps.C. §

15904.02(a); see *Keller Const. Co., Inc. v. Kashani* (1990) 220 CA3d 222, 228, 269 CR 259, 262—as *agent and beneficiary* of limited partnership, *sole* general partner bound by arbitration clause of contract entered into between partnership and third party; *and ¶ 2:15*]

(1) [2:24.2] **Limitation on liability to limited partners:** Although general partners are jointly and severally liable to *third parties* for tortious acts committed in the course of partnership business by other general partners (¶ 2:16), they are *not* liable to *limited partners* for another general partner's misdeeds *unless* they participated in the wrongdoing (through consent or otherwise) or negligently permitted it to occur. (Even so, the “innocent” general partners may be forced to *share* in any resulting loss to partnership capital in accordance with the allocation of profits and losses under the partnership agreement; *see ¶ 2:32*.) [*Kazanjian v. Rancho Estates, Ltd.* (1991) 235 CA3d 1621, 1625, 1629, 1 CR2d 534, 536, 538—general partner not jointly liable for losses to limited partner resulting from another general partner's misappropriations; compare *Miske v. Bisno* (2012) 204 CA4th 1249, 1258, 139 CR3d 626, 633—general partner jointly liable for losses to limited partner resulting from another general partner's misappropriations occurring *before* limited partner became limited partner (limited partner treated as innocent third party entitled to recover against both general partners)]

b. [2:25] **Limited partners as passive investors:** The limited partner is primarily a passive investor, and normally is not active in management and control of the business on a day-to-day basis.

(1) [2:26] **Right to information, accounting:** Even though the limited partners are “passive” investors, they have rights to information, reports and accountings from the partnership and to inspect partnership records. [See Corps.C. § 15903.04]

(2) [2:27] **Participation in management as creating risk of personal liability for partnership debts:** A limited partner normally is not liable for partnership debts (the partner's liability is limited to their investment in the partnership). However, a limited partner who *participates in the control* of the partnership business may be held personally liable to creditors who *actually knew* of such participation at the time of extending credit and who, based on the limited partner's conduct, *reasonably believed* the limited partner to be a general partner. [Corps.C. § 15903.03(a)]

(a) [2:27.1] **Activities *not constituting participation in management:*** The Code does not define what constitutes “participation in the control of the business” so as to make limited partners personally liable to creditors who reasonably believe them to be general partners. However, it does list a number of activities that do *not* constitute such participation. These include:

- Acting as an *employee*, agent or independent contractor for the limited partnership or a general partner;
- Consulting with and advising a general partner on partnership business, or serving on a committee that approves actions of the general partner;
- Being an officer, director or shareholder of a corporate general partner;
- Being a beneficiary, or a trustee, executor or other administrator, of an estate or trust (including a business trust) that is a general partner;
- Being a partnership creditor or debtor, or supplying collateral for the partnership, or guaranteeing partnership debts;
- Approving or disapproving an amendment to the partnership agreement;
- Voting on, proposing or calling a meeting of the partners;
- Calling, requesting, attending or participating in any meeting of the limited partners; and
- Acting to wind up the partnership after it has been dissolved. [See Corps.C. § 15903.03(b)(1)-(13), (c); *Gruendl v. Oewel Partnership, Inc.* (1997) 55 CA4th 654, 658-659, 64 CR2d 217, 219-220]

c. [2:28] **Class division of partnership interests:** Both limited and general partnership interests may be divided into classes having differing rights, powers and duties, as set forth in the partnership agreement. The various classes may be given the right to vote separately or together on any partnership matter. [Corps.C. § 15903.07]

d. [2:29] **Consideration for partnership interest:** Limited partnerships have greater flexibility than corporations in the consideration that may be given for an interest in the respective entity. A limited partner's contribution may consist of tangible

or intangible property "or other benefit" to the limited partnership, including money, services performed, promissory notes, an agreement to contribute cash or property, or a contract for services to be performed. [Corps.C. § 15905.01]

(1) [2:29.1] **Compare—limitations on consideration for corporate shares:** Corporate shares may *not* be issued in return for services *to be performed*, an *agreement* to contribute property or promissory notes (unless secured by collateral other than the shares themselves or the shares are issued pursuant to an employee stock purchase or option plan). [Corps.C. § 409(a)(1), *discussed at* ¶ 3:307 ff.]

[2:30] ***Reserved.***

e. [2:31] **Economic interest of limited partners:** A limited partnership is an entity distinct from its partners, who have *no direct ownership interest* in the limited partnership's assets. The limited partners' sole economic rights are to a share of the limited partnership's profits, losses and distributions. [Corps.C. § 15901.04(a); see Corps.C. §§ 15901.02(ak) & 15907.01 (partner's only transferable interest is right to receive distributions); *Evans v. Galardi* (1976) 16 C3d 300, 306, 128 CR 25, 30; also see *Everest Investors 8 v. McNeil Partners* (2003) 114 CA4th 411, 424, 8 CR3d 31, 40]

(1) [2:32] **Share of profits, losses, distributions:** Partnership profits, losses and distributions (including return of capital) are shared in proportion to the partners' contributions, unless the partnership agreement provides otherwise. [Corps.C. §§ 15905.03, 15905.035; and see *Kazanjian v. Rancho Estates, Ltd.* (1991) 235 CA3d 1621, 1629, 1 CR2d 534, 537-538—general and limited partners must share loss of partners' capital contributions in accordance with allocation of profits]

(2) [2:33] **Transfer of interest:** A limited partner has the right to assign their interest in whole or in part to a third person. But the assignment merely transfers the right to *receive distributions* from the partnership. It does not entitle the assignee to become substituted as a limited partner, unless the partnership agreement expressly so provides or *all general* partners and *a majority in interest* (in current profits) of *limited* partners consent. [Corps.C. §§ 15907.01, 15907.02(h)]

f. [2:33.1] **Corporation (or LLC) as general partner:** As stated, a limited partnership must have one or more *general* partners who manage the business and are *personally liable* for partnership debts (¶ 2:23). However, it is not necessary that an individual serve as general partner and thereby be exposed to creditor claims. Rather, a *corporation* (or *limited liability company*) may be the general partner. Ordinarily, the corporate shareholders (or LLC members) will not be personally liable for the debts of the enterprise (¶ 2:36.3, 2:38 ff.). And the shareholders, officers and/or directors of the corporate general partner (or the members and/or managers of the LLC general partner) may also hold limited partnership interests without losing their limited liability as limited partners of the limited partnership. [See Corps.C. § 15903.03(b)(1)]

• [2:33.2] **Caution:** The directors of a corporate general partner owe *fiduciary duties* to the limited partners; *see ¶ 6:252.2*.

g. [2:34] **Formalities required—certificate of limited partnership:** A limited partnership comes into existence upon filing a *certificate of limited partnership* with the Secretary of State. [Corps.C. § 15902.01(a), (c)]

(1) [2:34.1] **Contents:** The certificate must be signed and acknowledged by the *general* partners; and must show their names and addresses, the partnership's designated office in California, etc. However, the names of the *limited* partners and the amounts of their investments *need not be disclosed*. [Corps.C. §§ 15902.01(a) & (b), 15902.04(a)(1); see Corps.C. §§ 15901.02(e), 15901.14(a)(1)]

(2) [2:34.2] **Recordation not required:** The certificate *may*, but need not, be recorded with the county recorder. [Corps.C. § 15902.01(e)]

(3) [2:34.3] **Compare—optional written agreement:** The partners are *not* required to execute a written agreement to form a California limited partnership—i.e., their *oral* agreement suffices. [Corps.C. § 15901.02(x)]

• [2:34.4] **Comment:** Even so, prudence suggests that the partners *always* commit their understanding to a formal written agreement. Absent a writing that clearly defines the partners' respective rights and duties, the potential for misunderstandings and disputes is enormous.

h. [2:35] **Duration:** A general partner's death, withdrawal, removal, incompetence, bankruptcy or dissolution *dissolves the partnership ... unless* (1) at least one remaining general partner continues the business, or (2) where there is no remaining general partner, consent to continue the limited partnership and admit at least one general partner is given within 90 days by limited partners owning a majority of the rights to receive distributions. [Corps.C. § 15908.01(c)(2); see Corps.C. § 15906.03]

(1) [2:35.1] **Compare—limited partner's death, incompetency, etc.:** A limited partner's death, incompetence, bankruptcy or dissolution (or, where permitted by the partnership agreement, removal or withdrawal) has *no effect* on the *partnership*. (The effect on the *limited partner's interest* depends on the event and the terms of the partnership agreement;

generally, the limited partner's successor or legal representative may assume the limited partner's rights or may become entitled to partnership distributions with no right to vote or participate in management and only limited rights to partnership information.) [See Corps.C. §§ 15906.01, 15906.02, 15907.01, 15907.02, 15907.04, 15908.01; *also see ¶ 2:33*]

Cross-refer: For a comprehensive treatment of limited partnerships, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 5.

4. [2:36] **Limited Liability Company (LLC):** A hybrid between a partnership and a corporation, a limited liability company (LLC) combines the "pass-through" treatment of a partnership with the limited liability accorded corporate shareholders. [Corps.C. § 17701.01 et seq.; *People v. Pacific Landmark* (2005) 129 CA4th 1203, 1211-1212, 29 CR3d 193, 198; *Warburton/ Buttner v. Sup.Ct. (Tunica-Biloxi Tribe of La.)* (2002) 103 CA4th 1170, 1187-1188, 127 CR2d 706, 720]

[2:36a] *Current vs. prior law:* The paragraphs below (¶ 2:36b ff.) discuss the California Revised Uniform Limited Liability Company Act (Corps.C. § 17701.01 et seq.), which took effect January 1, 2014, and applies to all LLCs, including LLCs formed before 2014. However, with respect to LLCs formed before 2014, the current law applies only to "acts or transactions," or an operating agreement or other contracts entered into, *after 2013*. The prior law—the Beverly-Killea Limited Liability Act (repealed Corps.C. § 17000 et seq.)—will continue to govern all "acts or transactions" occurring, and any operating agreement or other contracts entered into, *before 2014*. [Corps.C. § 17713.04(a), (b)]

[2:36b] ***Caution:*** The LLC form of business entity is not available to most businesses rendering "professional services" (*see ¶ 2:36.36 ff.*)

a. [2:36.1] **Only one member required:** Like a corporation, which can have as few as one shareholder, an LLC need have only one "member" (i.e., owner). [Corps.C. §§ 17701.02(s), 17702.01(a)]

b. [2:36.2] **Separate legal entity:** Like limited partnerships and corporations, an LLC is recognized as a legal entity separate and apart from its "members" (i.e., its owners). [See Corps.C. §§ 17701.04(a), 17701.05; *PacLink Communications Int'l, Inc. v. Sup.Ct. (Yeung)* (2001) 90 CA4th 958, 963, 109 CR2d 436, 439; *Abrahim & Sons Enterprises v. Equilon Enterprises, LLC* (9th Cir. 2002) 292 F3d 958, 962 (applying Calif. law)]

c. [2:36.3] **Limited liability of members:** Ordinarily, only the LLC can be held responsible for the entity's debts. Subject to narrow exceptions (¶ 2:36.4 ff.), the LLC members are not personally liable for the entity's obligations and/or liabilities and thus enjoy the same "limited liability" as corporate shareholders (¶ 2:38 ff.). [Corps.C. § 17703.04(a)(2); see *CB Richard Ellis, Inc. v. Terra Nostra Consultants* (2014) 230 CA4th 405, 411, 178 CR3d 640, 644; *Kwok v. Transnation Title Ins. Co.* (2009) 170 CA4th 1562, 1571, 89 CR3d 141, 147-148; *People v. Pacific Landmark* (2005) 129 CA4th 1203, 1212, 29 CR3d 193, 199]

(1) Exceptions

(a) [2:36.4] **Guarantor liability:** LLC members may be personally liable for the entity's obligations if they *personally guaranteed* the obligations. [See Corps.C. § 17703.04(c), (e)]

(b) [2:36.5] **"Alter ego" liability:** A member may also be liable for an LLC's obligations under the common law "alter ego doctrine" (*see* ¶ 2:50 ff.) … except that the failure to hold or observe formalities pertaining to LLC member or manager meetings shall not be a factor establishing alter ego liability if the LLC's articles or operating agreement do not expressly require such meetings. [Corps.C. § 17703.04(b); see *Capon v. Monopoly Game LLC* (2011) 193 CA4th 344, 356-358, 122 CR3d 536, 546-547 & fn. 12]

[2:36.6 - 2:36.9] ***Reserved.***

d. [2:36.10] **Centralized management optional:** Management of an LLC's business and affairs is vested in all its members *unless* the articles of organization provide otherwise. [Corps.C. § 17704.07(a); see *PacLink Communications Int'l, Inc. v. Sup.Ct. (Yeung)* (2001) 90 CA4th 958, 963, 109 CR2d 436, 439]

(1) [2:36.11] **LLCs without centralized management ("member-managed"):** Where the articles do not provide for managers, LLC members' management and control rights are more akin to those of general partners of a general partnership than to limited partners or corporate shareholders.

(a) [2:36.11a] **No right to compensation:** As with partnerships, the fact that a member also performs management functions does not itself entitle the member to remuneration for services performed in a member-managed LLC (except

for reasonable compensation for services rendered in winding up the LLC's activities). But the operating agreement may provide for remuneration. [Corps.C. §§ 17704.07(e), 17707.04(c)]

(b) [2:36.12] **Voting interest ordinarily corresponds to interest in profits:** Each member has the right to vote *in proportion to such member's interest in the current profits* of the LLC … *unless* the articles of organization or operating agreement provides otherwise. Except for certain fundamental LLC matters (¶ 2:36.13), the vote of a *majority in interest* suffices. [Corps.C. § 17704.07(r)(1), (3)]

1) [2:36.13] **Unanimous vote requirement:** Unless the LLC's articles of organization or written operating agreement provides otherwise, a *unanimous* vote of all members is required to amend the articles or operating agreement. [Corps.C. § 17704.07(b)(5) & (r)(2)]

(c) [2:36.14] **Each member can bind LLC:** Where the LLC is managed by all its members, *each* member is deemed an *agent* of the LLC in dealings with third persons and can bind the LLC in the same way a general partner can bind a partnership (*¶ 2:15*). [Corps.C. § 17703.01(a)]

1) [2:36.15] **Compare—general partner's personal liability:** A member's acts may bind the LLC, but since members are generally not personally liable for LLC obligations, the acts would *not* subject the other members to *personal liability*. This is in contrast to general partners, whose acts could lead to personal liability on the part of other general partners (¶ 2:14 ff.).

(2) [2:36.16] **LLCs having designated managers ("manager-managed"):** An LLC's articles of organization may provide for "centralized management"—i.e., that the LLC's business and affairs shall be managed by or under the authority of one or more designated managers. Managers need not be members. [Corps.C. §§ 17702.01(b)(5), (6), 17704.07(a), (c)(1), (6); see *SB Liberty, LLC v. Isla Verde Ass'n, Inc.* (2013) 217 CA4th 272, 283, 158 CR3d 105, 113-114—sole manager may not delegate management to nonmember]

(a) [2:36.17] **Managers' liability:** No LLC manager is personally liable for any LLC debt, obligation or liability solely by reason of being a manager. (But a manager may *agree* to personal liability in the LLC articles of organization or a written operating agreement specifically referencing Corps.C. § 17703.04(e).) [Corps.C. § 17703.04]

Of course, an LLC manager, like a corporate officer (*¶ 6:283.4*) or director (*¶ 6:251.1 ff.*), may be personally liable to third persons harmed by *the LLC manager's own wrongful acts* … even when those acts were undertaken on the company's behalf. [Corps.C. § 17703.04(c); see *People v. Pacific Landmark* (2005) 129 CA4th 1203, 1212-1216, 29 CR3d 193, 198-202]

(b) [2:36.18] **Designation of "board of managers":** Some LLC operating agreements provide for a "board of managers." In doing so, the LLC mimics corporate law, with the consequence that a court may by analogy look to relevant *corporate* law when addressing the powers and duties of the LLC board … *unless* the members include specific provisions modifying those duties (to the extent permitted by the law governing LLCs) in the operating agreement. [See *ITV Gurney Holding Inc. v. Gurney* (2017) 18 CA5th 22, 32, 226 CR3d 496, 503-504 (citing text)—"Although the Company was established as a limited liability company rather than as a corporation, we interpret the establishment of a formal board as a choice by the Company to organize itself according to the ordinary rules of a board of directors"]

1) [2:36.18a] **Designation of "board of directors"?** Some LLC operating agreements provide for a "board of directors."

The law governing LLCs provides only for managers and makes no mention of directors. Attorneys cannot assume that the statutory and/or common law relating to *corporate* directors will automatically apply to LLC directors. The operating agreement should either spell out the duties and responsibilities of the LLC "directors" or state explicitly that their duties and responsibilities are those of directors of a California corporation. If the attorney wishes to spell out the LLC directors' duties and responsibilities, then the operating agreement should state *all* the board's responsibilities and authority, including its role in governance vis-à-vis the manager(s); how the directors are elected or appointed and their terms; how directors may be removed; the procedures for board meetings and actions; and the directors' duties and to whom the duties are owed. [See *Obeid v. Hogan* (Del. Ch. 2016) 2016 WL 3356851, *6-8 (unpub.)]

(3) [2:36.19] **Fiduciary duties to LLC and members:** An LLC member in a member-managed LLC, and an LLC manager in a manager-managed LLC, owes fiduciary duties of care and loyalty to the LLC and all its members in regard to LLC

operations. These duties include prohibitions against self-dealing and conflicts of interests. LLC managers and members must discharge their duties consistently with the obligations of good faith and fair dealing. [Corps.C. § 17704.09]

Members' and managers' duties may be modified only in a written operating agreement with the members' *informed consent*—i.e., upon adequate disclosure of the consequences. [Corps.C. § 17701.10(e)]

e. [2:36.20] **New members:** Unless otherwise provided in the operating agreement, no one can become a member of the LLC —either by issuance of a new membership or transfer of an existing one—without the consent of *all* members. [Corps.C. § 17704.01(c)]

(*Compare—partnerships:* Unless otherwise provided in the partnership agreement, no one can be admitted as a partner without the consent of *all* general partners (and a *majority in interest* of any limited partners). *See* ¶ *2:20, 2:33*.)

(1) [2:36.21] **Economic interests assignable:** Like a partner in a partnership, an LLC member can freely assign their rights to share in profits, losses, distributions, etc. (i.e., "economic rights") without causing a dissolution of the LLC, unless otherwise provided in the articles or operating agreement (*see* ¶ *2:20, 2:33*). However, such assignment may not transfer or effect any substitution of the member's voting, inspection and other rights except with the required consent of the other members (¶ 2:36.20). [Corps.C. § 17705.02(a)(1), (3)]

f. [2:36.22] **Duration:** An LLC is dissolved (1) upon the occurrence of an event (if any) set forth in the articles or written operating agreement, (2) by the vote of members having a majority in interest in current profits (or such greater percentage as may be specified in the articles or written operating agreement), (3) 90 days after the LLC has no members (but on a sole member's death, the member's status may pass to one or more of the member's heirs or successors), or (4) by judicial decree on the grounds specified in Corps.C. § 17707.03 (generally, events making continuation of the LLC imprudent or impracticable). [Corps.C. § 17707.01; see Corps.C. § 17701.02(m)]

This gives the LLC a somewhat more reliable continuity of interest than a partnership because the death, withdrawal, resignation, bankruptcy, etc. of an LLC member does *not* trigger a buy-out or dissolution of the LLC (unless the articles or operating agreement provides for a buy-out or dissolution upon one or more of these events) (*see* ¶ *2:21 ff., 2:35*).

[2:36.23 - 2:36.25] ***Reserved.***

g. [2:36.26] **Member's contribution:** A member need contribute only "any benefit" to the LLC in return for a membership interest. [Corps.C. §§ 17701.02(c), 17704.02]

[2:36.27] ***Reserved.***

(1) [2:36.28] **Compare—shareholder's contribution for corporate shares:** Here again, corporations are much more restrictive: Corporate shares can be issued only in return for money, property, past services, or cancelled debts or securities. [See Corps.C. § 409(a)(1), *discussed at* ¶ *3:307 ff.*]

h. [2:36.29] **Share of profits, losses, distributions:** LLC profits, losses and distributions are shared among the members as allocated by the operating agreement; otherwise, they are allocated in proportion to the value given to each member's capital contribution. [Corps.C. § 17704.04(a), (e)]

i. Required formalities

(1) [2:36.30] **Articles of organization:** The existence of an LLC begins upon the filing of *articles of organization* with the Secretary of State. [Corps.C. § 17702.01(d)] The person or persons who execute the articles need not be members. [Corps.C. § 17702.01(a)]

(a) [2:36.31] **Contents of articles:** The articles must be on the form prescribed by the Secretary of State. [Corps.C. § 17702.01(a)]

Among the items of information *required* on the form are a designation of a qualified initial agent for service of process and a statement indicating whether the LLC will be managed by one manager, more than one manager, or the members. [Corps.C. §§ 17702.01(b)(4), (5), (6), 17704.07(a)]

The articles need not disclose the managers' names, the members' names or the members' capital contributions.

FORM: The Secretary of State's standard form Limited Liability Company Articles of Organization (LLC-1) is available online at the Secretary of State's website (*www.sos.ca.gov*).

(2) [2:36.32] **Written or oral operating agreement:** The LLC is managed pursuant to the members' operating agreement. But the operating agreement need not be in writing; indeed, it may consist of no more than an oral—or even an "implied"—agreement among the initial members to organize the LLC. [Corps.C. § 17701.02(s)]

[2:36.33 - 2:36.35] ***Reserved.***

j. [2:36.36] **Limitation—not available to most "professionals":** A business rendering "*professional*" services requiring a license, registration or certification under the Business and Professions Code *cannot* operate as an LLC unless expressly authorized by statute (¶ 2:36.37). Although the term "professional" services has no precise definition, it likely refers to services that may lawfully be performed by a "professional corporation," such as law, medicine, dentistry and accountancy (*see ¶ 2:244 ff.*). [See Corps.C. § 17701.04(b), (e); 87 Ops.Cal.Atty.Gen. 109 (2004); also see Corps.C. §§ 13401(a), 13401.3; Stats. 1996, Ch. 57, § 30; Stats. 1994, Ch. 1200, § 93]

(1) [2:36.37] **Businesses authorized to operate as LLC:** At present, insurance agents, insurance brokers, licensed contractors, and cemetery authorities are the only businesses expressly authorized to operate in LLC form under the Business and Professions Code, so long as they provide "security for claims" and observe other statutory and regulatory conditions. [See Ins.C. §§ 1628, 1637, 1647.5; Bus. & Prof.C. §§ 7065(b), 7071.19, 7613.4; Health & Saf.C. § 7018]

(2) [2:36.38] **"Nonprofessional, occupational services" distinguished:** A business performing "non-professional, occupational services" may operate as an LLC. This is so even though the services require a license, registration or certification pursuant to the Business and Professions Code. [87 Ops.Cal.Atty.Gen. 109 (2004)—"Over 60 occupational activities require such a license, certification, or registration, including barbers, locksmiths, private detectives, alarm companies, structural pest control operators, electronic and appliance repair shops, and automotive repair dealers"; see Comment, 26 Cal.Bus.L.Rptr. 78-79 (2004)]

(3) [2:36.39] **Compare—limited liability partnership (accountants, architects, lawyers, engineers and land surveyors):** Although accountants, architects, lawyers, engineers and land surveyors cannot operate as an LLC, they may register their general partnership as a *limited liability partnership* (so long as they satisfy a statutory "security for claims" requirement) and thereby enjoy both limited liability and partnership tax treatment. *See discussion at ¶ 2:310 ff.*

Cross-refer: For a comprehensive treatment of limited liability companies, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 6.

5. Corporation

a. [2:37] **Separate legal entity status, generally:** A corporation is a separate legal entity existing under authority granted by state law. It has its own identity, separate and apart from the persons who created it and from its shareholders. [See generally, *Dole Food Co. v. Patrickson* (2003) 538 US 468, 474, 123 S.Ct. 1655, 1660; *Grosset v. Wenaas* (2008) 42 C4th 1100, 1108, 72 CR3d 129, 135; *North Valley Mall, LLC v. Longs Drug Stores Calif., LLC* (2018) 27 CA5th 598, 602, 238 CR3d 368, 371]

(1) [2:37.1] **Broad range of powers:** As a separate legal entity, a corporation has the power to act in any way permitted by the law that created it and by its own charter; e.g., to contract, to own and convey property, to sue and be sued. It is even capable of committing torts or crimes.

(2) Limitations

(a) [2:37.2] **Generally cannot appear in court in "pro per":** Although a corporation can sue or be sued in its name, it cannot appear in court "in propria persona." Nor can it appear on its own behalf as defendant in a criminal proceeding. Except in limited circumstances (*¶ 2:37.3 ff.*), the corporation must be *represented by a lawyer* in all cases. [*Merco Const. Engineers, Inc. v. Mun.Ct.* (1978) 21 C3d 724, 730, 147 CR 631, 634; *Rowland v. California Men's Colony, Unit II Men's Advisory Council* (1993) 506 US 194, 201-202, 113 S.Ct. 716, 721—corporation may appear in federal court only through licensed counsel; *United States v. Unimex, Inc.* (9th Cir. 1993) 991 F2d 546, 548—corporate criminal defendant cannot appear pro se]

1) [2:37.2a] **Opportunity to retain counsel:** A complaint improperly filed by a self-represented corporation raises a "curable defect" (the complaint is not void). As such, neither dismissal nor striking of the pro per corporation's

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

complaint is warranted where the other party suffered no prejudice thereby. Rather, the self-represented corporation should be given a reasonable opportunity to amend its complaint to show representation by a licensed attorney … on such terms as the court may deem just. (E.g., "[t]o the extent the opposing party is burdened by having to bring a motion to strike the complaint of a corporation not represented by counsel, the court, as a condition for granting leave to amend, may order the corporation to pay the opposing party's expenses for bringing the motion.") [See *CLD Const., Inc. v. City of San Ramon* (2004) 120 CA4th 1141, 1149-1150, 16 CR3d 555, 561]

2) [2:37.2b] **No shareholder intervention on corporation's behalf:** Even where a sole shareholder's interests are identical to those of the corporation, a nonlawyer shareholder *cannot intervene* in the proceeding as a method of circumventing the requirement that the corporation be represented by an attorney. To allow such intervention would permit the corporation to do *indirectly* what it may not do directly—i.e., appear other than by a licensed attorney. [See *United States v. High Country Broadcasting Co., Inc.* (9th Cir. 1993) 3 F3d 1244, 1245—intervention as of right (FRCP 24) cannot be used by shareholder as subterfuge to represent corporate defendant's interests]

3) [2:37.2c] **Attorney's withdrawal conditioned upon warning against pro se representation:** An attorney representing a client in an action or proceeding may withdraw without client consent only upon *court order* following a *noticed motion*. [CCP § 284(2)] The order relieving counsel must inform a corporate client that it may participate in the action only through an attorney and that failure to appoint an attorney may lead to an order striking its pleadings or entry of its default. [CRC 3.1362(e); see *Urethane Foam Experts, Inc. v. Latimer* (1995) 31 CA4th 763, 766-767, 37 CR2d 404, 406—defective notice vitiated corporate counsel's withdrawal and subsequent default judgment against corporation]

FORM: Order Granting Attorney's Motion to Be Relieved as Counsel—Civil (MC-053), available on the California Courts website (*www.courts.ca.gov*).

4) Exceptions

a) [2:37.3] **Small claims suit:** Any officer, director or employee may appear on the corporation's behalf in *small claims court*, or in superior court on a small claims appeal. [CCP §§ 116.540(b), 116.770(c); *Merco Const. Engineers, Inc. v. Mun.Ct.* (1978) 21 C3d 724, 731, 147 CR 631, 635]

b) [2:37.3a] **Administrative proceedings:** Corporations may be represented by nonlawyers, such as nonlawyer corporate officers, in proceedings before administrative agencies and tribunals (i.e., adjudicatory hearings before an administrative law judge). Administrative proceedings are less formal than proceedings in courts of record (i.e., superior courts and courts of appeal; see Cal. Const. Art. VI, § 1); consequently, there is less need for the services of a licensed attorney. [*Caressa Camille, Inc. v. Alcoholic Beverage Control App. Bd.* (2002) 99 CA4th 1094, 1101-1104, 121 CR2d 758, 763-766; see *Rogers v. Mun.Ct. (Solar Elec. Engineering, Inc.)* (1988) 197 CA3d 1314, 1318-1319, 243 CR 530, 532—nonlawyer may make procedural filings in administrative proceeding (e.g., file pro forma notice of appeal from administrative ruling)]

5) [2:37.3b] **Compare—other entities:** Here, a corporation is at no disadvantage when compared to most other legal entities. The rule against pro se representation applies to all entities generally regarded as "separate" from their owners, including *partnerships* and even *unincorporated associations*. [See *D-Beam Ltd. Partnership v. Roller Derby Skates, Inc.* (9th Cir. 2004) 366 F3d 972, 973-974; *Clean Air Transport Systems v. San Mateo County Transit Dist.* (1988) 198 CA3d 576, 578, 243 CR 799, 800; also see *Rowland v. California Men's Colony, Unit II Men's Advisory Council* (1993) 506 US 194, 202, 113 S.Ct. 716, 721]

(b) [2:37.3c] **Cannot proceed "in forma pauperis":** In forma pauperis rights are limited to natural persons. Thus, regardless of "indigence," corporations and other "artificial" entities are not eligible to proceed in forma pauperis. [*Rowland v. California Men's Colony, Unit II Men's Advisory Council* (1993) 506 US 194, 203-204, 113 S.Ct. 716, 722]

b. [2:38] **Liability for corporate debts:** As a separate legal entity, the corporation is responsible for its own debts. Normally, the shareholders, directors or officers of the corporation are *not* legally responsible for corporate liabilities. If there are losses in the business, the corporation bears them to the extent of its own resources; the stockholders indirectly bear them in that the value of their stock declines more or less in proportion to such losses.

(1) [2:39] **Distinguish—liability as guarantor, "alter ego" or culpable tortfeasor:** However, the shareholders may be held personally liable for corporate obligations if they have *personally guaranteed* them or if "*alter ego liability*" is

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

imposed. They may also be liable for their *own* tortious conduct in *ordering, authorizing or participating* in corporate wrongdoing. *See* *¶ 2:50 ff.*

c. [2:40] **Management and control:** Normally, management and control is vested in the board of directors, elected by the shareholders of the corporation. The directors generally make policy and major decisions but do not individually represent the corporation in dealing with third persons. Rather, such dealings are conducted through officers and employees, to whom authority is delegated by the directors. [See generally, *Grosset v. Wenaas* (2008) 42 C4th 1100, 1108, 72 CR3d 129, 135]

(1) [2:41] The same persons may be stockholders, directors and officers of the corporation (and usually are in small corporations). Although the shareholders elect the board of directors, they do not *directly* control the board's activities or decisions.

d. [2:42] **Formalities:** A corporation can be created only by compliance with the General Corporation Law, which requires filing of articles of incorporation containing certain essential provisions, prepayment of certain fees, etc. (*See ¶ 4:1 ff.*)

e. [2:43] **Duration:** As a separate legal entity, the corporation is capable of continuing indefinitely. Its existence is *not* affected by death or incapacity of its shareholders, officers or directors, or by transfer of its shares from one person to another.

f. [2:43.1] **Constitutional protections:** Corporations may exercise some—but not all—of the constitutional protections granted to natural persons.

(1) [2:43.2] **Not "citizens" within privileges and immunities clause:** Corporations are not "citizens" protected by the "privileges and immunities" clause of the Fourteenth Amendment to the U.S. Constitution (which prohibits states from abridging the "privileges and immunities" of U.S. citizens). [*Asbury Hosp. v. Cass County, N.D.* (1945) 326 US 207, 210-211, 66 S.Ct. 61, 63]

(2) [2:43.3] **Right to due process and equal protection:** However, corporations *do* have the right to *equal protection* and *due process* of law under the Fourteenth and Fifth Amendments, and under similar provisions of the California Constitution. [*Johnson v. Goodyear Mining Co.* (1899) 127 C 4, 8-9, 59 P 304, 305-306; *Pembina Consolidated Silver Mining & Milling Co. v. Commonwealth of Penn.* (1888) 125 US 181, 188-189, 8 S.Ct. 737, 740-741; *Gulf, C. & S.F. Ry. Co. v. Ellis* (1897) 165 US 150, 154, 17 S.Ct. 255, 256; *United States v. Unimex, Inc.* (9th Cir. 1993) 991 F2d 546, 550, *discussed at ¶ 2:43.3b*]

(3) [2:43.3a] **Freedom of speech:** So too, corporations enjoy First Amendment freedom of speech protection: i.e., absent narrowly-drawn restrictions serving compelling state interests, corporations have the right to express themselves on matters of public importance, whether or not those issues "materially affect" corporate business. [See *Citizens United v. Federal Election Comm'n* (2010) 558 US 310, 342-343, 355, 365, 130 S.Ct. 876, 899-900, 907, 913—government may not use speaker's corporate identity to suppress political speech by banning corporate contributions made to elect or defeat political candidates (overruling *Austin v. Michigan Chamber of Commerce* (1990) 494 US 652, 110 S.Ct. 1391); *First Nat'l Bank of Boston v. Bellotti* (1978) 435 US 765, 784, 98 S.Ct. 1407, 1420—asserted state purposes did not justify Mass. statute prohibiting corporate expenditures on referendum subjects]

(4) [2:43.3b] **Right to counsel:** Although a corporation cannot be imprisoned, a criminal action can result in fines and other penalties that could harm innocent shareholders, officers and other persons. A corporate criminal defendant thus has a Sixth Amendment *right to counsel*. [*United States v. Unimex, Inc.* (9th Cir. 1993) 991 F2d 546, 549-550]

However, since a corporation faces no incarceration risk, it has *no* right to *appointed counsel* where it cannot afford to retain private counsel. [*United States v. Unimex, Inc*., supra]

(5) [2:43.4] **No privilege against self-incrimination:** On the other hand, corporations (as well as LLCs and other "collective entities") have *no* privilege against *self-incrimination* (e.g., to prevent disclosure of incriminating corporate records or information). [*United States v. Kordel* (1970) 397 US 1, 7, 90 S.Ct. 763, 767, fn. 9; see *Matter of Twelve Grand Jury Subpoenas* (9th Cir. 2018) 908 F3d 525, 528 (per curiam); *Avant! Corp. v. Sup.Ct. (Nequist)* (2000) 79 CA4th 876, 883-886, 94 CR2d 505, 509-511]

(a) [2:43.4a] **No officer's or director's "derivative" privilege:** Nor may individuals assert the Fifth Amendment privilege to avoid producing corporate records which they possess in a *representative capacity* as officer or director of the corporation. This is so even though the records may be *personally* incriminating … and even though the person subpoenaed is the corporation's sole shareholder. [*Braswell v. United States* (1988) 487 US 99, 108-109, 108 S.Ct. 2284, 2290; *Matter of Twelve Grand Jury Subpoenas* (9th Cir. 2018) 908 F3d 525, 528-531; *Matter of Grand Jury Subpoenas Dated 10/22/91 & 11/1/91*(2nd Cir. 1992) 959 F2d 1158, 1163-1164]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) [2:43.4b] **Distinguish—testimony re records' *location:*** However, if the subpoenaed records are not in the officer's or director's *possession*, the Fifth Amendment privilege protects the individual from being compelled to disclose the records' *location*. (Such testimony would require the custodian to incriminate himself or herself by speaking the *contents of his or her own mind*.) [*In re Grand Jury Subpoena Dated 4/9/96 v. Smith* (11th Cir. 1996) 87 F3d 1198, 1201]

(b) [2:43.4c] **No privilege for former officers/directors:** The Fifth Amendment does not shield officers and directors from producing corporate records even where, prior to issuance of the records subpoena, the corporation *dissolved* (*Bellis v. United States* (1974) 417 US 85, 96, 94 S.Ct. 2179, 2187, fn. 3) or the officer's or director's relationship with the corporation *terminated* (*In re Grand Jury Subpoena Dated 11/12/91* (11th Cir. 1992) 957 F2d 807, 810-812).

(c) [2:43.4d] **Compare—sole proprietorships:** In contrast, a sole proprietor *can* assert the privilege against self-incrimination in response to a subpoena of proprietorship records. Reason: Such records are the *personal property* of the owner; in producing them, the proprietor acts for himself or herself, not in a *representative* capacity. [*United States v. Doe* (1984) 465 US 605, 608, 104 S.Ct. 1237, 1240; see *Matter of Twelve Grand Jury Subpoenas* (9th Cir. 2018) 908 F3d 525, 528-531]

(6) [2:43.5] **Limited right to privacy:** The extent to which a corporation (or partnership or LLC) has a right of privacy is something of an open issue. [See *SCC Acquisitions, Inc. v. Sup.Ct. (Western Albuquerque Land Holdings, LLC)* (2015) 243 CA4th 741, 754-756, 196 CR3d 533, 544-545—"The extent of any privacy rights of a business entity is unsettled" (*discussed at ¶ 2:43.5 ff.*); *Nativi v. Deutsche Bank Nat'l Trust Co.* (2014) 223 CA4th 261, 314, 167 CR3d 173, 216, fn. 16 (collecting cases); *S.B.C.C., Inc. v. St. Paul Fire & Marine Ins. Co.* (2010) 186 CA4th 383, 396, 112 CR3d 40, 50, fn. 6]

(a) [2:43.6] **Privacy right under California Constitution?** Courts are divided on the question whether corporations (and other business entities) have a privacy right under the California Constitution (Cal. Const. Art. I, § 1):

- Most cases hold that this constitutional right is limited to "people"—meaning *natural* persons—and *not* corporations. [*SCC Acquisitions, Inc. v. Sup.Ct. (Western Albuquerque Land Holdings, LLC)* (2015) 243 CA4th 741, 755-756, 196 CR3d 533, 544-545; *Ameri-Medical Corp. v. Workers' Compensation App. Bd.* (1996) 42 CA4th 1260, 1286-1287, 50 CR2d 366, 383; *Roberts v. Gulf Oil Corp.* (1983) 147 CA3d 770, 791, 195 CR 393, 406]

- However, one case held that the purpose of the constitutional privacy right is to prevent excessive intrusion into matters normally regarded as confidential, and that this right applies to *business entities* as well as individuals. [*H & M Assocs. v. City of El Centro* (1980) 109 CA3d 399, 409-412, 167 CR 392, 399-401—limited partnership could bring invasion of privacy action against city that disrupted plaintiff's business by disseminating negative, nonpublic information about plaintiff]

(b) [2:43.7] **Common law privacy right?** Courts are also divided on the question whether corporations can assert a common law right of privacy:

- One case held that the common law right of privacy applies only to *individuals*, and thus a corporation cannot bring an action for invasion of privacy arising from the unlawful recording of a telephone conversation. [*Ion Equip. Co. v. Nelson* (1980) 110 CA3d 868, 878-879, 168 CR 361, 366]

- However, later cases state that while corporations do not have a "fundamental," constitutional right to privacy (¶ 2:43.6), they have a lesser, "general" right to privacy, the extent of which depends on the circumstances. "Two critical factors are the strength of the nexus between the artificial entity and human beings and the context in which the controversy arises." [*Roberts v. Gulf Oil Corp.* (1983) 147 CA3d 770, 791-793, 796-797, 195 CR 393, 406-409, 411 (but holding that privacy right did not bar county tax assessor from obtaining corporation's internal "interpretive data" for purpose of valuing corporation's oil and gas properties); *SCC Acquisitions, Inc. v. Sup.Ct. (Western Albuquerque Land Holdings, LLC)* (2015) 243 CA4th 741, 756, 196 CR3d 533, 545 (*discussed at ¶ 2:43.8*)]

1) [2:43.8] **Civil litigation discovery:** Following the view that business entities have a "general" right to privacy, several courts employed a "balancing test" to determine whether discovery into a corporation's (or other business entity's) internal records should be permitted under specified conditions. [See *SCC Acquisitions, Inc. v. Sup.Ct.*

(Western Albuquerque Land Holdings, LLC) (2015) 243 CA4th 741, 756, 196 CR3d 533, 545—plaintiff granted discovery of corporate defendant's internal records to determine whether affiliated corporations could be added as alter ego judgment debtors (*see* ¶ *2:57.4*); *Ameri-Medical Corp. v. Workers' Compensation App. Bd*. (1996) 42 CA4th 1260, 1286-1289, 50 CR2d 366, 383-385—professional medical corporation retained privacy interest in financial and employment information unrelated to preparation of medical reports sought by insurers in workers' comp proceedings; see also *Hecht, Solberg, Robinson, Goldberg & Bagley v. Sup.Ct. (Panther)* (2006) 137 CA4th 579, 594-596, 40 CR3d 446, 456-458—former client who settled malpractice claim against law firm (limited liability partnership) could obtain firm's financial and insurance information to show value of claim in subsequent malpractice action against attorney who handled claim (assuming without deciding that business entity had privacy rights)]

[2:43.9 - 2:43.10] ***Reserved.***

(c) [2:43.11] **No corporate privacy right under federal Freedom of Information Act:** The federal Freedom of Information Act (5 USC § 551 et seq.) requires federal agencies to make certain records available to the public upon request, but it also exempts from such disclosure records or information compiled for law enforcement purposes that could constitute "an unwarranted invasion of personal privacy." [5 USC § 552(b)(7)(C)]

Although the Act defines "person" to include a "corporation" (5 USC § 551(2)), the term "personal privacy" refers to the privacy interests of *natural* persons. Corporations do *not* have "personal privacy" that would justify nondisclosure of federal records under the "personal privacy" exemption. [*Federal Communications Comm'n v. AT & T Inc.* (2011) 562 US 397, 402-409, 131 S.Ct. 1177, 1181-1185]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 2-B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki ‘Vicki’ Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 2. Substantive Law Considerations in Choosing Business Entity: Tax and Nontax Factors

B. Comparison of Nontax Consequences

1. [2:44] Personal Liability for Business Debts
  a. [2:48] Personal guaranties may be required
  b. [2:49] Insurance may cover corporate obligations
  c. [2:50] “Alter ego” liability
    (1) [2:51] Requirements
      (a) [2:51.1] Unity of interests
      (b) [2:51.2] Resulting injustice
    (2) [2:51.3] Presumption *against alter ego liability*
    (3) [2:52] Application
      (a) [2:52.1] Requirement that “injustice” would otherwise result
        1) [2:52.1a] No “wrongful intent” requirement
        2) [2:52.2] Contract vs. tort claims
          a) [2:52.4b] Compare—no alter ego liability for injuries covered by workers' comp
          b) [2:52.4c] Distinguish—personal liability for shareholder's own torts
        3) [2:52.4d] Use of corporation to evade statute
      (b) [2:52.5] Shareholders jointly and severally liable
        1) [2:52.6] Limitation—liability limited to active shareholders
        2) [2:52.6a] Venue for alter ego claims—no shareholder transfer to county of residence
      (c) [2:52.7] Subsidiaries
        1) [2:52.7a] No parent liability to subsidiary's employees absent independent duty
        2) [2:52.7f] “Integrated enterprise” test in employment discrimination cases
        3) [2:52.7g] Compare—antitrust liability
        4) [2:52.7h] Cross-refer—CERCLA liability
      (d) [2:52.8] “Brother/sister” corporations (“single-enterprise” or “common-enterprise” doctrine)
        1) [2:52.8a] Factors considered
      (e) [2:52.9] Compare—alter ego liability under federal law
        1) [2:52.10] “Single employer” liability under labor law
          a) [2:52.11] Avoidance of union agreement as motive
          b) [2:52.12] Factors considered
          c) [2:52.12d] Compare—no “reverse alter ego” claim
        2) [2:52.13] “Single employer” liability under WARN Act
          a) [2:52.14] Department of Labor criteria

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

3) [2:52.20] Alter ego liability for ERISA pension fund contributions
4) [2:52.21] No fiduciary relationship arising from alter ego liability under bankruptcy law
(4) [2:53] Effect of undercapitalization?
(a) [2:56.1] What constitutes "adequate" capitalization
(b) [2:57] Comment
(5) [2:57.2] Effect of "alter ego" liability on corporate status—corporation not dissolved
(a) [2:57.2a] Thus, a judgment against a…
(b) [2:57.3] Further, a corporate entity may…
(6) [2:57.4] Amending judgment to add alter ego as judgment debtor
(7) [2:57.4d] Collateral estoppel effect of alter ego adjudication
(a) [2:57.4e] Application
(8) [2:57.5] Compare—alter ego doctrine not a "defensive weapon"
(a) [2:57.5a] Controlling shareholder cannot rest on "alter ego" status to avoid third party tort liability
(b) [2:57.5b] Third party wrongdoer cannot invoke alter ego doctrine as defense against corporation's suit
(c) [2:57.5c] Alter ego doctrine cannot defeat RICO liability
(d) [2:57.5d] Sole shareholder cannot disregard corporate signatory to contract
1) Application
2) [2:57.5f] Distinguish—nonparty sued as alter ego may invoke contractual arbitration provision
(e) [2:57.5g] No use of alter ego doctrine to claim "sham guaranty"
(f) [2:57.5h] No use of alter ego doctrine to invoke property tax benefit available only to natural person
(g) [2:57.5k] Distinguish—corporation may invoke alter ego doctrine to counter attorney's conflict of interest
(9) [2:57.5*l*] Corporation may not pierce own veil
(a) [2:57.5m] Compare—alter ego claim by trustee in bankruptcy
(10) [2:57.6] No "reverse piercing" by controlling shareholder's creditors to obtain corporate assets
(a) [2:57.6a] Exception—federal tax liabilities
(b) [2:57.6e] Compare—LLC
(11) [2:57.7] No shareholder piercing to obtain corporate assets
(a) [2:57.8] No "equitable" right to corporate assets for purpose of claiming bankruptcy exemption
(12) [2:57.9] No shareholder piercing to obtain corporation's insurance coverage
(13) [2:57.10] No shareholder piercing to use corporation's contractor's license
(14) [2:57.11] Distinguish—jurisdiction over foreign parent based on subsidiary's California activities
(a) [2:57.11a] Federal constitutional test
1) [2:57.11b] "General" jurisdiction
2) [2:57.11c] "Specific" jurisdiction
(b) [2:57.11h] Subsidiary as parent's agent
1) [2:57.11i] "Representative services" as variant of agency
2) [2:57.11j] Continued viability of agency and "representative services" doctrines?
3) [2:57.12] Alter ego doctrine contrasted
(c) [2:57.13] "Purposeful availment"
(15) [2:57.16] Cross-refer—personal liability under common law and federal and state statutes
d. [2:58] Impact
2. [2:59] Continuity
3. [2:63] Transferability of Interests
a. [2:64] Agreements restricting transfer of corporate shares

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b. [2:65] Securities law restrictions applicable to corporate shares
c. [2:66] Impact
4. [2:67] Management and Control
a. [2:68] Advantages of corporate form
b. [2:69] Compare—partnerships
c. [2:69.1] Compare—LLCs
d. [2:70] Impact
5. Cost Considerations
a. Formation costs
(1) [2:74] Compare—limited partnership and LLC
(2) [2:75] Fictitious business name filing
b. [2:76] Legal fees
c. [2:77] Accounting fees
d. [2:78] Payroll taxes
6. [2:79] Other Considerations
a. [2:80] Simplicity of operation
b. [2:81] Anonymity of ownership
(1) [2:81.1] Compare—federal FinCEN reporting requirements
(2) [2:82] Compare—general partnership
(3) [2:83] Compare—limited partnership
(4) [2:83.1] Compare—LLC

1. [2:44] **Personal Liability for Business Debts:** One of the most important concerns for an investor is personal liability for debts incurred by the business enterprise. The investor usually realizes that losses sustained by the business may wipe out the amount invested; the concern is whether creditors of the business can reach the investor's personal resources *beyond* the amount invested, if the business assets prove insufficient.

[2:45] As discussed above (¶ *2:4 ff., 2:14 ff.*), sole proprietors or general partners put their entire personal wealth at risk; on the other hand, limited partners, LLC members, LLP partners and corporate shareholders generally do not (i.e., the limited partner, LLC member, LLP partner and corporate shareholder normally risk only the amount invested).

[2:46] However, limited partners are supposed to be "passive" investors with no active role in management of the corporate business (otherwise, they risk personal liability for its debts; ¶ *2:27*).

[2:47] Consequently, for investors who propose to be regularly active in the business, the corporate form (or possibly an LLC or, for certain professionals (*see* ¶ *2:310*), an LLP) would be the preferred choice … if all other factors balance out equally. But other factors are rarely equal. While limited liability for corporate debts is always an important consideration for passive investors in a new enterprise, the limited liability of individuals intending to organize and take an active role in a closely-held corporation may be largely *illusory* for the following reasons:

a. [2:48] **Personal guaranties may be required:** First of all, banks and others extending credit to a small corporation frequently require that the shareholders give their personal guaranties. Also, such guaranties are frequently required for *leases* and other long-term corporate obligations (especially on dealings with government and financial institutions).

b. [2:49] **Insurance may cover corporate obligations:** Most businesses carry liability insurance to cover claims based on *torts* committed by agents or employees; and such insurance often extends to fire, theft and employee dishonesty. To the extent such insurance coverage exists, the business is protected and the owners have no risk of personal liability (other than for the deductible or "retention" amount) whether or not the business is incorporated.

c. [2:50] **"Alter ego" liability:** In certain cases, the corporate entity may be disregarded (the corporate veil "pierced") and the shareholders held personally liable for corporate debts because of the manner in which they have dealt with the corporation.

(1) [2:51] **Requirements:** There are two basic requirements:

(a) [2:51.1] **Unity of interests:** First, the shareholders sought to be held liable have treated the corporation as their "alter ego," rather than as a separate entity (i.e., there must be such "*unity of interest" and ownership* that the individuality or *separateness* of the corporation *has ceased to exist* or never existed in the first place). [*Mesler v. Bragg Mgmt. Co.* (1985) 39 C3d 290, 300, 216 CR 443, 448; *Automotriz del Golfo de Calif. S.A. De C.V. v. Resnick* (1957) 47 C2d 792,

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

796, 306 P2d 1, 3; *Hacker v. Fabe* (2023) 92 CA5th 1267, 1276, 310 CR3d 192, 199; see also *SEC v. Hickey* (9th Cir. 2003) 322 F3d 1123, 1128-1129, amended 335 F3d 834—person who controlled but did not own corporation could not be liable as alter ego under California law]

(b) [2:51.2] **Resulting injustice:** Second, it would "sanction a fraud or promote an injustice" to uphold the corporate entity and allow the shareholders to escape personal liability for its debts. [*Automotriz del Golfo de Calif. S.A. De C.V. v. Resnick* (1957) 47 C2d 792, 796, 306 P2d 1, 3; *Mesler v. Bragg Mgmt. Co.* (1985) 39 C3d 290, 300, 216 CR 443, 448; *Gopal v. Kaiser Found. Health Plan, Inc.* (2016) 248 CA4th 425, 431-432, 203 CR3d 549, 553-554; *Hasso v. Hapke* (2014) 227 CA4th 107, 155-157, 173 CR3d 356, 395-397]

(2) [2:51.3] **Presumption *against alter ego liability:*** In practice, courts regard the alter ego doctrine as a *drastic remedy* and disregard the corporate form only *reluctantly* and *cautiously*. This is because alter ego liability is fundamentally at odds with the general rule that a de jure corporation is a legal entity *separate* from its owners (¶ 2:37); and the law specifically *permits* owners to incorporate a business for the *very purpose* of shielding them from its liabilities. [See *Eleanor Licensing LLC v. Classic Recreations LLC* (2018) 21 CA5th 599, 615-617, 230 CR3d 511, 525-526; *Gopal v. Kaiser Found. Health Plan, Inc.* (2016) 248 CA4th 425, 431-432, 203 CR3d 549, 553-554; *Highland Springs Conference & Training Ctr. v. City of Banning* (2016) 244 CA4th 267, 281, 199 CR3d 226, 236; *Toho-Towa Co., Ltd. v. Morgan Creek Productions, Inc.* (2013) 217 CA4th 1096, 1107, 159 CR3d 469, 479]

Accordingly, the burden of pleading and establishing alter ego liability is on the plaintiff creditor. [See *Minifie v. Rowley* (1921) 187 C 481, 488, 202 P 673, 676; *Cascade Energy & Metals Corp. v. Banks* (10th Cir. 1990) 896 F2d 1557, 1576-1577 (abrogation on other grounds recognized by *Banner Bank v. Smith* (2022) 30 F4th 1232, 1241)]

(3) [2:52] **Application:** The alter ego doctrine is usually applied where there are only a few shareholders and they have not respected their corporation's *separate identity*; for example, where the shareholders:

• Fail to contribute capital, issue stock or otherwise complete formation of the corporation;

• Use corporate assets as their own (e.g., withdraw corporate funds for personal use without treating such withdrawals as salaries or dividends);

• Commingle corporate funds with their personal funds; or

• Fail to observe corporate formalities (e.g., fail to regularly elect directors, appoint officers, hold board meetings and keep minutes or file corporate tax returns). [See *Hacker v. Fabe* (2023) 92 CA5th 1267, 1276-1277, 310 CR3d 192, 199 (noting that no single factor is determinative, and that courts must look at all circumstances to determine whether doctrine should be applied); *Misik v. D'Arco* (2011) 197 CA4th 1065, 1073-1074, 130 CR3d 123, 129-130; *Zoran Corp. v. Chen* (2010) 185 CA4th 799, 810-811, 110 CR3d 597, 606-607—triable factual issue whether shareholders so disregarded corporations' separate identities as to render them shareholders' alter egos; *Mid-Century Ins. Co. v. Gardner* (1992) 9 CA4th 1205, 1212-1213, 11 CR2d 918, 922 & fn. 3]

(a) [2:52.1] **Requirement that "injustice" would otherwise result:** Despite evidence that shareholders disregarded the corporate entity's "separateness," alter ego liability will not be imposed *unless* upholding the corporate shield under the facts would *result in an injustice*.

"The alter ego doctrine does not guard every unsatisfied creditor of a corporation but instead affords protection where some conduct amounting to bad faith makes it inequitable for the corporate owner to hide behind the corporate form." Claimants seeking to pierce the corporate veil must show the manner in which they were harmed by a shareholder's abusive conduct toward the corporation or some other "injustice" or "inequity" that would result from recognition of the corporate entity. [See *Sonora Diamond Corp. v. Sup.Ct. (Sonora Union High School Dist.)* (2000) 83 CA4th 523, 539, 99 CR2d 824, 837; *Highland Springs Conference & Training Ctr. v. City of Banning* (2016) 244 CA4th 267, 281, 199 CR3d 226, 236; *Hasso v. Hapke* (2014) 227 CA4th 107, 155, 173 CR3d 356, 395; *Leek v. Cooper* (2011) 194 CA4th 399, 418, 125 CR3d 56, 70—"Difficulty in enforcing a judgment does not alone satisfy this element"]

1) [2:52.1a] **No "wrongful intent" requirement:** An "injustice" is present *as a matter of law* where the corporate entity is *insolvent*, leaving a creditor with no way to satisfy a valid judgment absent application of the alter ego doctrine. The creditor need not prove that the alter egos acted with a fraudulent or wrongful intent to avoid a debt

or injure a creditor; it is sufficient that the alter egos' acts produced an inequitable *result*. Their intent "is beside the point." [*Relentless Air Racing, LLC v. Airborne Turbine Ltd. Partnership* (2013) 222 CA4th 811, 813, 815-816, 166 CR3d 421, 422, 424-425; *Toho-Towa Co., Ltd. v. Morgan Creek Productions, Inc.* (2013) 217 CA4th 1096, 1109, 159 CR3d 469, 481, fn. 5—"Application of the alter ego doctrine does not depend upon pleading or proof of fraud"; *Misik v. D'Arco* (2011) 197 CA4th 1065, 1074, 130 CR3d 123, 130]

2) [2:52.2] **Contract vs. tort claims:** Courts are more likely to find the requisite "injustice"—and thus pierce the corporate veil—for tort claimants than for contract creditors. [See, e.g., *Cascade Energy & Metals Corp. v. Banks* (10th Cir. 1990) 896 F2d 1557, 1577 (abrogation on other grounds recognized by *Banner Bank v. Smith* (2022) 30 F4th 1232, 1241)]

Rationale: The alter ego analysis necessarily differs where the claim is based on *consensual* dealings with the corporation (e.g., breach of contract) as distinguished from claims arising from *nonconsensual* transactions (e.g., tort):

• [2:52.3] Presumably, contract claimants seeking to pierce the corporate veil *voluntarily* chose to deal with the corporate entity and to look only to it (and its credit) for payment, rather than securing added protection through personal guarantees of the shareholders, security agreements, or other potentially available devices. Hence, allowing contract creditors recourse against a shareholder's personal assets accords them an "unbargained for" *windfall* … unless the shareholder's mistreatment of the corporation exposed the creditors to *unexpected risk* (e.g., misrepresentation or commingling, or diversion of corporate assets). [*Cascade Energy & Metals Corp. v. Banks* (10th Cir. 1990) 896 F2d 1557, 1577 (abrogation on other grounds recognized by *Banner Bank v. Smith* (2022) 30 F4th 1232, 1241); see generally, *Matter of Sims* (5th Cir. 1993) 994 F2d 210, 218-219]

• [2:52.4] On the other hand, no similar "windfall" results when alter ego liability is recognized in favor of a corporation's tort creditors … since their claims do not involve any element of *voluntary* dealing with ability to protect against loss. [See *Cascade Energy & Metals Corp. v. Banks* (10th Cir. 1990) 896 F2d 1557, 1577 (abrogation on other grounds recognized by *Banner Bank v. Smith* (2022) 30 F4th 1232, 1241)]

[2:52.4a] ***Reserved.***

a) [2:52.4b] **Compare—no alter ego liability for injuries covered by workers' comp:** Where the corporation has satisfied its obligation to "secure the payment" of workers' compensation benefits for its employees (Lab.C. § 3700), the employees can suffer no "injustice" in receiving the statutorily-mandated compensation for their work-related injuries. Indeed, permitting vicarious recovery from "alter ego" shareholders would have the effect of exempting corporate employees from the workers' compensation "exclusive remedy rule" (Lab.C. § 3602(a)), thus giving them an "unwarranted windfall." [*Doney v. TRW, Inc.* (1995) 33 CA4th 245, 250-251, 39 CR2d 292, 295-296]

b) [2:52.4c] **Distinguish—personal liability for shareholder's own torts:** Apart from potential liability under the alter ego doctrine, and even when alter ego liability is not warranted, shareholders are personally liable if they directly *ordered, authorized or participated* in a corporation's tortious conduct. In such circumstances, the shareholders' liability does not arise from their positions as shareholders, but from *their own affirmative misconduct*. (Shareholder tort liability is thus similar to director and officer tort liability; *see* ¶ *6:250.1 ff., 6:283.4*.) [*Filet Menu, Inc. v. C.C.L. & G., Inc.* (2000) 79 CA4th 852, 866, 94 CR2d 438, 447; see *Wyatt v. Union Mortg. Co.* (1979) 24 C3d 773, 785, 157 CR 392, 399]

Indeed, where shareholders are found directly liable, alter ego liability is superfluous. [*Filet Menu, Inc. v. C.C.L. & G., Inc.*, supra]

3) [2:52.4d] **Use of corporation to evade statute:** An injustice may result where the corporate entity is used to circumvent a statute or otherwise frustrate a statutory policy. In such circumstances, the court may disregard the corporate entity and treat the acts as if they were done by the controlling shareholders. [See *Say & Say, Inc. v. Ebershoff* (1993) 20 CA4th 1759, 1769-1770, 25 CR2d 703, 710-711—corporation was alter ego of litigious shareholder whose use of corporation was solely to avoid "vexatious litigant" statute; *People v. Anderson* (1991) 1 CA4th 1084, 1091-1092, 3 CR2d 247, 251—corporate entity disregarded when used by shareholder to avoid statutory restrictions on sale of liquor license; also see *H.A.S. Loan Service, Inc. v. McColgan* (1943) 21 C2d 518, 521, 133 P2d 391, 394—brother/sister corporations that divided loan charges to avoid usury and banking laws regarded as single entity]

(b) [2:52.5] **Shareholders jointly and severally liable:** When the alter ego doctrine applies, a corporation's shareholders are treated as "partners" and held jointly and severally liable for its debts. [*Hiehle v. Torrance Millworks, Inc.* (1954) 126 CA2d 624, 630, 272 P2d 780, 784; *Minnesota Mining & Mfg. Co. v. Sup.Ct. (Schwartz)* (1988) 206 CA3d 1025, 1028, 253 CR 908, 909-910]

Ownership of even *one share* may be sufficient to impose alter ego liability. [See *Riddle v. Leuschner* (1959) 51 C2d 574, 580, 335 P2d 107, 111]

1) [2:52.6] **Limitation—liability limited to active shareholders:** However, alter ego liability is limited to shareholders who *influence and govern* the corporation or who were actors "in the course of conduct constituting the abuse of the corporate privilege." [*American Home Ins. Co. v. Travelers Indemnity Co.* (1981) 122 CA3d 951, 966, 175 CR 826, 834]

Thus, an inactive shareholder who *passively benefits* from another's disregard of the corporate entity is not subject to alter ego liability. [*Firstmark Capital Corp. v. Hempel Fin'l Corp.* (9th Cir. 1988) 859 F2d 92, 95—no alter ego liability as to *nonparticipating spouse* whose community interest in stock benefited from *husband's* commingling and other corporate abuses]

And there has been no reported case in which the passive shareholders of a *publicly-traded corporation* have been held liable for its debts. [See *McKesson HBOC, Inc. v. New York State Common Retirement Fund, Inc.* (9th Cir. 2003) 339 F3d 1087, 1094-1096]

2) [2:52.6a] **Venue for alter ego claims—no shareholder transfer to county of residence:** Actions against a corporation may be brought either in the county where (i) it has its principal place of business, (ii) the contract was made or to be performed, or (iii) the obligation or liability arose or the breach occurred. [CCP § 395.5]

Ordinarily, an action against an individual should be brought in the individual's county of residence (CCP § 395(a)). However, the effect of properly-pleaded alter ego allegations (shareholder failed to observe corporate formalities, commingled funds, inadequately capitalized the corporation, etc.) is to treat the corporation and the shareholder as the *same entity*, and thus make the shareholder a *co-obligor* on the claim against the corporation. Under CCP § 395.5, an action against a corporation and a shareholder joined on an alter ego theory is properly venued where the action could be commenced against the *corporate defendant* (e.g., where the contract was entered into with the corporation or where the corporate breach occurred); and the *shareholder cannot transfer* the action to the shareholder's county of residence. [*Lebastchi v. Sup.Ct. (Poway Wal-Mart Plaza)* (1995) 33 CA4th 1465, 1470, 39 CR2d 787, 790]

(c) [2:52.7] **Subsidiaries:** It is well recognized that "[t]he law permits the incorporation of businesses for the very purpose of isolating liabilities among separate entities"—i.e., parent and subsidiary corporations. [See, e.g., *Cascade Energy & Metals Corp. v. Banks* (10th Cir. 1990) 896 F2d 1557, 1576 (abrogation on other grounds recognized by *Banner Bank v. Smith* (2022) 30 F4th 1232, 1241)] Thus, a parent corporation will *not* be held liable for its *subsidiary's* debts simply because of its stock ownership or the existence of common directors and officers.

Alter ego liability will be imposed on a parent corporation only if (i) the parent controlled the subsidiary to such a degree that it was a "mere instrumentality" of the parent used for an *improper purpose*, *and* (ii) an inequitable result would otherwise occur. [*Laird v. Capital Cities/ABC, Inc.* (1998) 68 CA4th 727, 742, 80 CR2d 454, 463 (declined to follow on other grounds by *Reid v. Google, Inc.* (2010) 50 C4th 512, 524, 113 CR3d 327, 337)—"plaintiff must show 'specific manipulative conduct' by the parent toward the subsidiary which 'relegate[s] the latter to the status of merely an instrumentality, agency, conduit or adjunct of the former …'"; *Tomaselli v. Transamerica Ins. Co.* (1994) 25 CA4th 1269, 1285, 31 CR2d 433, 443; *M/V American Queen v. San Diego Marine Const. Corp.* (9th Cir. 1983) 708 F2d 1483, 1489-1490]

1) [2:52.7a] **No parent liability to subsidiary's employees absent independent duty:** A parent-subsidiary relationship is not itself sufficient to subject the parent to tort liability for injury suffered by the subsidiary's employees from unsafe workplace conditions. "Rather, the parent corporation may be liable only if it assumes a duty to act by *affirmatively undertaking to provide a safe working environment at the subsidiary's workplace*." [*Waste Mgmt. Inc. v. Sup.Ct. (Guzman)* (2004) 119 CA4th 105, 110, 13 CR3d 910, 914 (emphasis added)]

The test here is similar to the "undue control" test used to impose alter ego liability (¶ 2:52.7):

• [2:52.7b] A parent's denial of the subsidiary's ability to correct known workplace hazards, exercised by control over the subsidiary's budget, was not an "affirmative undertaking" that rendered the parent liable for an employee's death: It is common for a parent to control a subsidiary's budget. Moreover, there was no "inequitable result" … because the subsidiary fulfilled its obligation as an employer to carry workers' compensation insurance (Lab.C. § 3700; *see*¶ *2:52.4b*). [*Waste Mgmt. Inc. v. Sup.Ct. (Guzman)* (2004) 119 CA4th 105, 110, 112-113, 13 CR3d 910, 914, 916; *see*¶ *2:52.4b*]

[2:52.7c - 2:52.7e] ***Reserved.***

2) [2:52.7f] **"Integrated enterprise" test in employment discrimination cases:** A more complex "integrated enterprise" test is used in cases seeking to hold a parent corporation liable for its subsidiary's acts of unlawful employment discrimination. [See *Laird v. Capital Cities/ABC, Inc.* (1998) 68 CA4th 727, 737-738, 80 CR2d 454, 460-461 (case arising under Fair Employment and Housing Act (Gov.C. § 12900 et seq.)); *Mathews v. Happy Valley Conference Ctr., Inc.* (2019) 43 CA5th 236, 248, 256 CR3d 497, 508-509 (case arising under Title VII (42 USC § 2000e et seq.)); and further discussion in Chin, Wiseman, Callahan & Lowe, *Cal. Prac. Guide: Employment Litigation* (TRG), Ch. 7]

3) [2:52.7g] **Compare—antitrust liability:** A parent and a wholly owned subsidiary always have a "unity of purpose" and thus act as a "single enterprise" whenever they engage in "coordinated activity." For this reason, a subsidiary that engages in anticompetitive activities with its parent may have antitrust liability even though the subsidiary did *not* have an illegal, anticompetitive *purpose*. [*Arandell Corp. v. Centerpoint Energy Services, Inc.* (9th Cir. 2018) 900 F3d 623, 625, 630-631 (applying federal principles to Wisconsin law); see *Copperweld Corp. v. Independence Tube Corp.* (1984) 467 US 752, 771-772, 104 S.Ct. 2731, 2741-2742]

4) [2:52.7h] **Cross-refer—CERCLA liability:** Parent corporations may be liable under CERCLA for environmental contamination attributable to their subsidiaries. *See discussion at*¶ *6:597.1 ff.*

(d) [2:52.8] **"Brother/sister" corporations ("single-enterprise" or "common-enterprise" doctrine):** As in the case of parent/subsidiary corporations, the alter ego doctrine may be applied between two or more corporations *under common ownership* if (i) one corporation so dominated and controlled the finances, policies and practices of the other corporation that the other corporation was merely a "*conduit*" or *instrumentality* of the controlling corporation in pursuit of a *single business venture* ("single enterprise," also known as "common enterprise"), and (ii) disregard of the separate nature of the corporations is necessary to prevent an injustice upon one corporation's creditors. The assets of all the "brother/sister" corporations may be subject to the claims of a creditor of any one of the corporations (or of the "alter ego" shareholders), and a constructive trust for the creditor's benefit may be imposed on the corporations' assets. [See *Gopal v. Kaiser Found. Health Plan, Inc.* (2016) 248 CA4th 425, 431-432, 203 CR3d 549, 553-554; *Toho-Towa Co., Ltd. v. Morgan Creek Productions, Inc.* (2013) 217 CA4th 1096, 1107-1108, 159 CR3d 469, 479-480 & fn. 4; *Las Palmas Assocs. v. Las Palmas Ctr. Assocs.* (1991) 235 CA3d 1220, 1249-1251, 1 CR2d 301, 318; compare *LSREF2 Clover Property 4, LLC v. Festival Retail Fund 1, LP* (2016) 3 CA5th 1067, 1081-1082, 208 CR3d 200, 211-213, *discussed at* ¶ *2:57.5g*]

1) [2:52.8a] **Factors considered:** Factors tending to show the existence of a "single enterprise" are:

• Participation in a common venture or in a similar or functionally reciprocal business (e.g., one corporation builds houses upon land owned by the other);

• Identical equitable ownership;

• Common directors, officers and employees;

• Same business location, telephone numbers and email systems;

• Pooling of assets and revenues, or use of one corporation's financial resources to pay or guarantee the other's obligations (especially if the other corporation is undercapitalized; *see*¶ *2:53 ff.*);

• The corporations tend to benefit jointly from transactions entered into by one of them. [*Butler America, LLC v. Aviation Assur. Co., LLC* (2020) 55 CA5th 136, 146, 269 CR3d 284, 292; *Toho-Towa Co., Ltd. v. Morgan Creek*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Productions, Inc. (2013) 217 CA4th 1096, 1108-1109, 159 CR3d 469, 480-481; *Las Palmas Assocs. v. Las Palmas Ctr. Assocs.* (1991) 235 CA3d 1220, 1249-1250, 1 CR2d 301, 318-319]

(e) [2:52.9] **Compare—alter ego liability under federal law:** The Ninth Circuit has developed its own generalized substantive law on disregard of the corporate entity.

As under California law, a two-prong analysis is employed, focusing upon (i) the amount of respect the shareholders give to the corporation's separate identity and (ii) the injustice that would result from recognition of the corporate entity (*see*¶ *2:51 ff.*). However, under federal law, claimants seeking to pierce the corporate veil may show, in lieu of "resulting injustice," that the shareholders formed the corporation with the *fraudulent intent* of evading civil or criminal liability. [*UA Local 343 United Ass'n of Journeymen & Apprentices of Plumbing & Pipefitting Industry of U.S. & Canada, AFL-CIO v. Nor-Cal Plumbing, Inc.* (9th Cir. 1994) 48 F3d 1465, 1475—triable factual issue whether shareholder liable for fringe benefit contributions owed by corporation under collective bargaining agreement (¶ 2:52.10 ff.); *Ministry of Defense of the Islamic Republic of Iran v. Gould, Inc.* (9th Cir. 1992) 969 F2d 764, 769 & fn. 3—no alter ego liability for amounts owed by corporation to foreign government under partly performed contract; *Seymour v. Hull & Moreland Engineering* (9th Cir. 1979) 605 F2d 1105, 1111—no alter ego liability for unpaid fringe benefits owed by corporation under collective bargaining agreement; *Board of Trustees of Mill Cabinet Pension Trust Fund for Northern Calif. v. Valley Cabinet & Mfg. Co.* (9th Cir. 1989) 877 F2d 769, 774—shareholder not liable for corporation's ERISA obligation to employee pension fund]

1) [2:52.10] **"Single employer" liability under labor law:** The alter ego or "single employer" doctrine as developed in *labor* law is analytically different from the traditional alter ego (i.e., "veil-piercing") doctrine as developed in corporate law. The former is designed to prevent employers from escaping their *collective bargaining* obligations by shifting work to nonunion firms they also own ("double-breasted" operations); it bears little relation to the corporate alter ego doctrine that allows corporate creditors to pierce the corporate shell to hold shareholders liable for corporate debts. [*UA Local 343 United Ass'n of Journeymen & Apprentices of Plumbing & Pipefitting Industry of U.S. & Canada, AFL-CIO v. Nor-Cal Plumbing, Inc.* (9th Cir. 1994) 48 F3d 1465, 1475; *Southern Calif. Painters & Allied Trades, Dist. Council No. 36 v. Rodin & Co., Inc.* (9th Cir. 2009) 558 F3d 1028, 1032]

a) [2:52.11] **Avoidance of union agreement as motive:** Two or more corporations (or other business entities) constituting a "single employer" may be liable for one corporation's obligations under a collective bargaining agreement where the obligor deliberately sought to avoid the agreement by, e.g., willfully diverting its customers to the other corporation or engaging in a *sham transfer* of its business (e.g., asset sale or reorganization). [*UA Local 343 United Ass'n of Journeymen & Apprentices of Plumbing & Pipefitting Industry of U.S. & Canada, AFL-CIO v. Nor-Cal Plumbing, Inc*. (9th Cir. 1994) 48 F3d 1465, 1472; *National Labor Relations Bd. v. O'Neill* (9th Cir. 1992) 965 F2d 1522, 1529; see *Resilient Floor Covering Pension Fund v. M&M Installation, Inc.* (9th Cir. 2010) 630 F3d 848, 852-854 (*discussed at*¶ *2:52.20*)]

b) [2:52.12] **Factors considered:** The most important factor in determining "single employer" status is *centralized control of labor relations.* Other relevant factors include:

• Common management;

• Interrelation of operations; and

• Common ownership and financial control.

No single factor is controlling, and all need not be present. [*UA Local 343 United Ass'n of Journeymen & Apprentices of Plumbing & Pipefitting Industry of U.S. & Canada, AFL-CIO v. Nor-Cal Plumbing, Inc.* (9th Cir. 1994) 48 F3d 1465, 1471; *National Labor Relations Bd. v. O'Neill* (9th Cir. 1992) 965 F2d 1522, 1529; *A. Dariano & Sons, Inc. v. District Council of Painters No. 33* (9th Cir. 1989) 869 F2d 514, 518-519]

[2:52.12a - 2:52.12c] ***Reserved.***

c) [2:52.12d] **Compare—no "reverse alter ego" claim:** As stated above (¶ *2:52.10*), the alter ego or "single employer" doctrine applies where a *union* employer opens a *nonunion* company to avoid *existing* collective bargaining obligations. It does not apply where a *nonunion* employer allegedly opens a *union* company to which

it diverts selected projects in order to avoid *prospective* collective bargaining obligations. “The alter ego doctrine was never intended to coerce a nonunion company into becoming a union company by requiring its compliance with a collective bargaining agreement it never signed, with a union its employees never authorized to represent them.” [*Southern Calif. Painters & Allied Trades, Dist. Council No. 36 v. Rodin & Co., Inc.* (9th Cir. 2009) 558 F3d 1028, 1032-1033]

2) [2:52.13] **“Single employer” liability under WARN Act:** Two separate entities may be treated as a “single employer” liable to its workers under the Federal Worker Adjustment and Retraining Notification Act (WARN Act, 29 USC §§ 2101-2109, *see*¶ *8:1042 ff.*) for failure to provide at least 60 days' notice of a “plant closing” or “mass layoff.”

a) [2:52.14] **Department of Labor criteria:** Under DOL regulations, whether two companies are treated as one or as separate entities depends on their degree of *independence*. Some of the factors to be considered are:

• Common ownership;

• Common directors and/or officers;

• De facto exercise of control;

• Unity of personnel policies emanating from a common source; and

• Dependency of operations. [20 CFR § 639.3(a)(2)]

However, these regulations are intended only to reflect state corporate and federal law dealing with “alter ego” or “single employer” liability. The central inquiry under the WARN Act is basically the same as under federal labor law (¶ 2:52.10 ff.): whether one entity has structured its relationship with the other in such a fashion as to control the other and, at the same time, avoid obligations imposed under federal law. [*International Brotherhood of Teamsters, Chauffeurs, Warehousemen & Helpers, Gen. Truck Drivers, Office Food & Warehouse Local 952 v. American Delivery Service Co., Inc.* (9th Cir. 1995) 50 F3d 770, 776—factual issue whether parent and subsidiary constituted “single employer” under WARN Act; see *Guippone v. BH S & B Holdings LLC* (2nd Cir. 2013) 737 F3d 221, 226—application of regulatory factors “requires a fact-specific inquiry, no one factor set out by the DOL is controlling, and all factors need not be present for liability to attach”; *Childress v. Darby Lumber, Inc.* (9th Cir. 2004) 357 F3d 1000, 1005-1007]

[2:52.15 - 2:52.19] ***Reserved.***

3) [2:52.20] **Alter ego liability for ERISA pension fund contributions:** Liability for unpaid contributions to a pension fund may be imposed upon a collective bargaining agreement *nonsignatory* that is the *alter ego* of the *signatory*. Liability will be imposed upon proof that (i) the two firms have common ownership, management, operations and labor relations, and (ii) the nonsignatory firm is used in a sham or fraudulent effort to avoid the signatory's ERISA obligation. [*Resilient Floor Covering Pension Fund v. M&M Installation, Inc.* (9th Cir. 2010) 630 F3d 848, 851-855]

4) [2:52.21] **No fiduciary relationship arising from alter ego liability under bankruptcy law:** The alter ego doctrine does not itself create a fiduciary relationship; nor does it impose on the alter ego shareholder a preexisting fiduciary relationship that the corporation may have with others. “Instead of creating, enforcing, or expounding on substantive duties, California's alter ego doctrine merely acts as a procedural mechanism by which an individual can be held jointly liable for the wrongdoing of his or her corporate alter ego.” [*Double Bogey, L.P. v. Enea* (9th Cir. 2015) 794 F3d 1047, 1051-1052]

• [2:52.22] A corporation that was the general partner of a limited partnership and the managing member of a limited liability company had fiduciary duties (under California law) toward the limited partner and the nonmanaging member, respectively. But these fiduciary duties were not ipso facto imposed on the corporation's alter ego shareholders for the purpose of 11 USC § 523(a)(4), which provides that liabilities created by a *fiduciary's defalcation* are *not dischargeable* in bankruptcy. Thus, the limited partnership and the LLC could not bar discharge of the bankrupt corporation's bankrupt shareholders on the ground that the alter ego doctrine further ascribed the

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

corporation's fiduciary defalcation to its *shareholders*. [*Double Bogey, L.P. v. Enea* (9th Cir. 2015) 794 F3d 1047, 1051-1053]

(4) [2:53] **Effect of undercapitalization?** Inadequate capitalization of a corporation, in view of its planned operations, is certainly *a factor* courts consider important in determining whether to "pierce the corporate veil." [See *Minton v. Cavaney* (1961) 56 C2d 576, 579-580, 15 CR 641, 643; *Butler America, LLC v. Aviation Assur. Co., LLC* (2020) 55 CA5th 136, 146, 269 CR3d 284, 292 (recognizing undercapitalization as "important factor in determining alter ego liability"); *Las Palmas Assocs. v. Las Palmas Ctr. Assocs.* (1991) 235 CA3d 1220, 1250, 1 CR2d 301, 318]

[2:54] But it is not clear whether inadequate capitalization by itself is sufficient ground for "alter ego" liability—i.e., where there is no evidence of commingling, improper use of corporate funds, lack of corporate formalities, etc.

• [2:55] Language in some cases suggests inadequate capitalization by itself *is* ground for "piercing" the corporate veil and holding the shareholders liable. [See *Automotriz del Golfo de Calif. S.A. De C.V. v. Resnick* (1957) 47 C2d 792, 799, 306 P2d 1, 4; *Laborers Clean-Up Contract Admin. Trust Fund v. Uriarte Clean-Up Service, Inc.* (9th Cir. 1984) 736 F2d 516, 524—emphasizing adequate capitalization equally if not more important than compliance with corporate formalities; *Nilsson, Robbins et al. v. Louisiana Hydrolec* (9th Cir. 1988) 854 F2d 1538, 1543-1544—corporate president owning 30% of corporation's stock found alter ego on ground corporation undercapitalized]

• [2:56] But no case has expressly so held; and other decisions state inadequacy of capital is *not* itself enough to render shareholders personally liable for corporate debts. [*Arnold v. Browne* (1972) 27 CA3d 386, 396, 103 CR 775, 782 (overruled on other grounds by *Reynolds Metals Co. v. Alperson* (1979) 25 C3d 124, 129, 158 CR 1, 3)—"Evidence of inadequate capitalization is, at best, merely a factor to be considered by the trial court in deciding whether or not to pierce the corporate veil"; *Harris v. Curtis* (1970) 8 CA3d 837, 841, 87 CR 614, 617; compare *Ministry of Defense of the Islamic Republic of Iran v. Gould, Inc.* (9th Cir. 1992) 969 F2d 764, 769-770, and *Seymour v. Hull & Moreland Engineering* (9th Cir. 1979) 605 F2d 1105, 1113—under federal law, inadequate capitalization may evidence "fraudulent intent" (*see* ¶ *2:52.9*)]

(a) [2:56.1] **What constitutes "adequate" capitalization:** *See* ¶ *3:29 ff.*

(b) [2:57] **Comment:** If inadequate capital alone were ground for piercing the corporate veil, shareholders would rarely be protected … because undercapitalization is *common* with new corporations. But this assumes some good faith attempt was made to put capital at risk (even if it turned out to be inadequate).

The situation is quite different where the organizers failed to invest any money at all or put up only token amounts; or where the principals reduce an operating corporation to a mere shell by stripping it of its assets (see *Jack Farenbaugh & Son v. Belmont Const., Inc.* (1987) 194 CA3d 1023, 1033-1034, 240 CR 78, 83-84). Alter ego liability is more likely in such cases.

[2:57.1] ***Reserved.***

(5) [2:57.2] **Effect of "alter ego" liability on corporate status—corporation not dissolved:** A corporation does not "dissolve" when found to be the alter ego of its shareholders. Rather, in the interest of justice (¶ 2:52.1), for certain limited purposes, "a hole will be drilled in the wall of limited liability erected by the corporate form; for all purposes other than that for which the hole was drilled, the wall still stands." [*Mesler v. Bragg Mgmt. Co.* (1985) 39 C3d 290, 301, 216 CR 443, 449; see *Greenspan v. LADT, LLC* (2010) 191 CA4th 486, 511, 121 CR3d 118, 137-138]

(a) [2:57.2a] Thus, a judgment against a corporation and its alter ego is enforceable against each separately. [*Mesler v. Bragg Mgmt. Co.* (1985) 39 C3d 290, 216 CR 443]

(b) [2:57.3] Further, a corporate entity may be recognized for tax purposes, yet be deemed the alter ego of its shareholders so as to make them individually liable for its taxes. [See *Wolfe v. United States* (9th Cir. 1986) 798 F2d 1241, 1243, amended 806 F2d 1410, 1411]

(6) [2:57.4] **Amending judgment to add alter ego as judgment debtor:** Upon motion, a judgment against a corporation may be amended to add as a judgment debtor a *nonparty* alter ego who *controlled* the underlying litigation and whose *interests* were therefore represented in the lawsuit. This is an "equitable procedure" based on the theory that, because the alter ego controlled the underlying litigation to represent its own interests, the court is simply inserting the "correct name of the real defendant" rather than adding a "new defendant." [*Highland Springs Conference & Training Ctr. v. City of Banning* (2016) 244 CA4th 267, 280-281, 199 CR3d 226, 235-236; see *Highland Springs Conference & Training Ctr. v.*

City of Banning (2019) 42 CA5th 416, 422-423, 426, 255 CR3d 331, 336, 338-339—attorney fees incurred in amending judgment to add alter ego were *pre*judgment costs governed by CRC 3.1702(b) (not *post*judgment costs governed by CRC 3.1702(c)(1) or CCP §§ 685.040, 685.070 or 685.080); *Danko v. O'Reilly* (2014) 232 CA4th 732, 747-751, 181 CR3d 304, 316-319 (individual defendant dismissed on directed verdict later added as judgment debtor); *Wells Fargo Bank, N.A. v. Weinberg* (2014) 227 CA4th 1, 6-9, 173 CR3d 113, 117-119 (attorney added as judgment debtor to judgment against his professional corporation)]

However, alter ego shareholders *cannot* be added by amending the judgment where the corporation's liability was not actually litigated (i.e., judgment was obtained by *default*) or where the alter egos' and corporation's interests were not identical (i.e., the shareholders' interests were not represented in the litigation). Instead, the alter egos must be sued in a separate action in which their status and liability as alter egos (*see*¶ 2:52 ff.), as well as the validity of the plaintiff's claims, can be litigated. [See, e.g., *Motores De Mexicali, S.A. v. Sup.Ct. (Resnick)* (1958) 51 C2d 172, 175, 331 P2d 1, 3; also see *Wolf Metals Inc. v. Rand Pac. Sales, Inc.* (2016) 4 CA5th 698, 703-704, 708-709, 209 CR3d 198, 202-203, 206-207; *Katzir's Floor & Home Design, Inc. v. M-MLS.com* (9th Cir. 2004) 394 F3d 1143, 1149-1150—amending judgment against corporation to add principal as judgment debtor violated due process where, although principal controlled litigation, he was not named individually, knew corporation was near dissolution, and had no personal duty to defend underlying litigation; compare *Lopez v. Escamilla* (2022) 79 CA5th 646, 652-653, 295 CR3d 63, 68-69—no due process violation where judgment creditor sued alleged alter ego personally to recover default judgment against corporation instead of summary proceeding to add him to existing judgment; and further discussion in Ahart, *Cal. Prac. Guide: Enforcing Judgments & Debts* (TRG), Ch. 6G]

[2:57.4a - 2:57.4c] ***Reserved.***

(7) [2:57.4d] **Collateral estoppel effect of alter ego adjudication:** An adjudication of "alter ego" status in one proceeding may be given collateral estoppel ("issue preclusion") effect in a subsequent proceeding, *provided* (a) the alter ego issue was *actually litigated on the merits* in the first proceeding, *and* (b) the party sought to be bound by the prior adjudication was either a party to the prior proceeding *or* had a sufficiently close relationship to the proceeding to ensure its interests were adequately represented. Such a relationship may exist if the alter ego in effect *controlled* the prior litigation and had a financial interest in its outcome. [See *In re Daily* (9th Cir. 1991) 940 F2d 1306, 1308; and see generally, CCP § 1908(b)—use of collateral estoppel against person not a party to previous proceeding]

(a) [2:57.4e] **Application:** Corporate officer was held in contempt for failing to produce corporate records subpoenaed by a governmental agency. In the subsequent bankruptcy of the officer's father, the trustee in bankruptcy asserted the father should be collaterally estopped from using those records to refute the trustee's claim that the corporation was the father's alter ego and its separate existence should therefore be disregarded. The appellate court rejected the argument and remanded the case.

The alter ego issue *had never been litigated* in the first proceeding. Moreover, neither the corporation nor the father *was a party* to the first proceeding, and there was insufficient evidence of a control relationship among the father, son and corporation. [*In re Daily* (9th Cir. 1991) 940 F2d 1306, 1308]

(*Comment:* The trustee's attempt in *Daily* to treat the corporation as the father's alter ego predated a California court's rejection of the "reverse piercing" doctrine; *see*¶ *2:57.6*.)

(8) [2:57.5] **Compare—alter ego doctrine not a "defensive weapon":** The alter ego doctrine provides the basis for an *affirmative* cause of action by corporate creditors; it is *not* a "defense" that can be asserted by the corporation or its alter egos. [See *Capon v. Monopoly Game LLC* (2011) 193 CA4th 344, 356-358, 122 CR3d 536, 546-547 & fn. 12; *McCarthy v. Azure* (1st Cir. 1994) 22 F3d 351, 362-363—corporate principal individually sued by seller of corporation could not invoke alter ego doctrine to avail himself of his buyer-corporation's right to arbitration in purchase agreement; *Lumpkin v. Envirodyne Indus., Inc.* (7th Cir. 1991) 933 F2d 449, 459-463—parent corporation could not assert alter ego doctrine to benefit from settlement and release entered into by subsidiary]

(a) [2:57.5a] **Controlling shareholder cannot rest on "alter ego" status to avoid third party tort liability:** Thus, although an alter ego finding necessarily assumes the shareholder "alter egos" are one and the same with their corporate entity, such shareholders may still incur third party tort liability—e.g., for intentional interference with a corporate contract.

Ownership and control of an entity does not itself relieve an owner, director or manager from tort liability for interfering with the entity's contracts. Rather, defendant escapes liability only if defendant was acting to protect the entity's interests. In contrast, alter ego liability is not predicated on a defendant's intent to advance the interests of a corporation and may be imposed only when its use will avoid a fraud or injustice (¶ *2:52.1*); "it is difficult to imagine what equitable goal would be served by using the alter ego doctrine to defeat … [a third party interference with contract] claim … We reject such use of the alter ego doctrine—it is designed not to provide an escape from liability but to prevent abuse." [*Shapoff v. Scull* (1990) 222 CA3d 1457, 1471-1472, 272 CR 480, 487-488 (disapproved on other grounds by *Applied Equip. Corp. v. Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 521, 28 CR2d 475, 485, fn. 10)—alter ego finding did not bar judgment holding D liable for tortious interference with contract; *Webber v. Inland Empire Investments, Inc.* (1999) 74 CA4th 884, 897-901, 88 CR2d 594, 602-604 (same)]

(b) [2:57.5b] **Third party wrongdoer cannot invoke alter ego doctrine as defense against corporation's suit:** Similarly, a corporation's status as a "sham" with no identity separate from its shareholders does not preclude it from bringing suit against third parties … including third parties whose negligence allegedly allowed the shareholders to manipulate the corporation as part of a fraudulent scheme. Where the corporation remains liable to innocent creditors, the corporation may recover for *distinct and cognizable harm that it suffered* notwithstanding wrongdoing by its shareholders. [*Loyd v. Paine Webber, Inc.* (9th Cir. 2000) 208 F3d 755, 758—trustee for bankrupt corporation used by shareholders to issue fraudulent insurance policies could bring malpractice suit against corporation's former attorneys for failing to prevent fraud (but recovery denied because complaint failed to state viable malpractice claim)]

(c) [2:57.5c] **Alter ego doctrine cannot defeat RICO liability:** The Racketeer Influenced and Corrupt Organizations Act (RICO, 18 USC §§ 1961-1968) makes it unlawful for "any *person* employed by or associated with any *enterprise* … to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity …" [18 USC § 1962(c) (emphasis added)]

The existence of two separate entities—a "person" and an "enterprise"—is a prerequisite to RICO liability. A corporation and its sole shareholder/president satisfy that requirement; and the alter ego doctrine is *inapplicable*. "The corporate owner/employee, a natural person, is distinct from the corporation itself, a legally different entity with different rights and responsibilities due to its different legal status. And we can find nothing in the statute that requires more 'separateness' than that." [See *Cedric Kushner Promotions, Ltd. v. King* (2001) 533 US 158, 160, 163, 121 S.Ct. 2087, 2089, 2091]

(d) [2:57.5d] **Sole shareholder cannot disregard corporate signatory to contract:** A shareholder/officer who enters into a contract expressly in the name of the corporation cannot thereafter disregard the corporation and claim they were the de facto contracting party.

1) Application

• [2:57.5e] Where a corporation that entered into a construction contract lacked a contractor's license (a statutory bar to payment for services as a contractor; see Bus. & Prof.C. § 7031), the shareholder/president—who held a contractor's license—could not thereafter claim the corporation was merely his alter ego. "An individual who has obtained the benefits of corporate limited liability will not be permitted to repudiate corporate existence just because the corporation has become an inconvenience." [*Opp v. St. Paul Fire & Marine Ins. Co.* (2007) 154 CA4th 71, 76, 64 CR3d 260, 265]

2) [2:57.5f] **Distinguish—nonparty sued as alter ego may invoke contractual arbitration provision:** A shareholder of a corporation that entered into a contract containing an arbitration provision may compel arbitration when sued for breach of contract on an alter ego theory. Moreover, arbitration may extend to related *noncontract* claims, such as statutory claims arising from the shareholder/director's dissolution of the corporation without notifying or providing for its creditors (Corps.C. §§ 316(a), 1903(c), 2011). To the extent the claims *rely on* the contract, plaintiff is estopped from avoiding the arbitration provision. Moreover, it is unfair to attempt to hold a shareholder liable under the contract without availing the shareholder of its benefits. [*Rowe v. Exline* (2007) 153 CA4th 1276, 1284-1290, 63 CR3d 787, 792-798—bought-out shareholder sued corporate signatory and nonparty shareholders/directors who dissolved corporation without making final buyout payment]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(e) [2:57.5g] **No use of alter ego doctrine to claim "sham guaranty":** California's antideficiency laws (CCP §§ 580a et seq., 726) prohibit a lender from obtaining a deficiency judgment against a borrower following a nonjudicial foreclosure of real property. However, the antideficiency laws ordinarily do *not* extend to *guarantors*. [CCP § 580d(b); see *LSREF2 Clover Property 4, LLC v. Festival Retail Fund 1, LP* (2016) 3 CA5th 1067, 1074-1075, 208 CR3d 200, 206-207]

Neither the alter ego doctrine nor the single enterprise doctrine may be used to assert that a guaranty of a corporation's (or other entity's) debt was a sham and that the guarantor is in reality a *primary obligor* entitled to the protections of the antideficiency laws. Where the lender neither structured the transaction nor knew, when making the loan, of the borrower's failure to follow corporate formalities, application of the alter ego or single enterprise doctrine to avoid a deficiency judgment "would promote an inequitable result, exactly what the doctrine is designed to avoid." Quite simply, "[g]uarantors could choose to avoid liability by instructing their affiliated companies to disregard corporate formalities." [*LSREF2 Clover Property 4, LLC v. Festival Retail Fund 1, LP*, supra, 3 CA5th at 1081-1082, 208 CR3d at 211-213; see *CADC/RADC Venture 2011-1 LLC v. Bradley* (2015) 235 CA4th 775, 788-790, 185 CR3d 684, 694-696—alter ego doctrine not applied where borrower observed corporate formalities and guarantor could not otherwise show grounds for disregarding borrower's corporate form; compare *Valinda Builders, Inc. v. Bissner* (1964) 230 CA2d 106, 110, 40 CR 735, 737—individuals who purchased property in their names but later assigned property to wholly-owned corporation and guarantied its debt to seller entitled to antideficiency laws' protection because individuals in essence guarantied their own debt]

(f) [2:57.5h] **No use of alter ego doctrine to invoke property tax benefit available only to natural person:** The sole shareholder of a corporation that owns the house in which the shareholder resides cannot invoke the alter ego doctrine to claim a property tax benefit available by statute (Rev. & Tax.C. § 69.5) only to a natural person. [*Grotenhuis v. County of Santa Barbara* (2010) 182 CA4th 1158, 1164, 105 CR3d 918, 922—plaintiff "should not be able to weave in and out of corporate status when it suits the business objective of the day"]

[2:57.5i - 2:57.5j] ***Reserved.***

(g) [2:57.5k] **Distinguish—corporation may invoke alter ego doctrine to counter attorney's conflict of interest:** In a situation involving parent and subsidiary corporations, one case holds that the parent may invoke the alter ego doctrine to disqualify the subsidiary's attorney from simultaneously representing an interest adverse to the parent in a pending litigation matter (CRPC 1.7; formerly CRPC 3-310(C)). Although allowing the corporation to assert its own alter ego status may appear unfair, tolerating an attorney's breach of loyalty to the corporations would wreak greater inequity. [*Brooklyn Navy Yard Cogeneration Partners, L.P. v. Sup.Ct. (Parsons Corp.)* (1997) 60 CA4th 248, 256-259, 70 CR2d 419, 424-426 (*discussed further at ¶ 1:11.7k*)]

(9) [2:57.5*l*] **Corporation may not pierce own veil:** The alter ego doctrine may *not* be applied to allow a corporation to disregard its *own* incorporation and status as a separate entity. The doctrine is intended to *protect third parties*, hence, the corporation may not assert the doctrine to obtain an *advantage against a third party*. [*Pacific Landmark Hotel, Ltd. v. Marriott Hotels, Inc.* (1993) 19 CA4th 615, 628, 23 CR2d 555, 563—subsidiary could not claim interest through parent to obtain contract rights against third party]

(a) [2:57.5m] **Compare—alter ego claim by trustee in bankruptcy:** Typically, alter ego claims are asserted when the corporation lacks sufficient assets to pay a plaintiff creditor's claim. If the corporation is in bankruptcy, a question may arise whether an alter ego claim is properly brought by the creditor or the trustee in bankruptcy.

The trustee in bankruptcy stands in the debtor corporation's shoes. Therefore, the trustee may bring an alter ego claim (i.e., the claim is property of the bankruptcy estate) if there is injury to the *corporation* that gives *the corporation a right of action against the shareholders*. (Examples include fraudulent transfers of corporate property for less than adequate consideration and conversion of corporate assets.) Absent a *corporate* right of action, a claim that shareholders treated the corporation as their alter ego to the detriment of a corporate creditor may be asserted only by the *injured creditor*. [*Shaoxing County Huayue Import & Export v. Bhaumik* (2011) 191 CA4th 1189, 1198-1199, 120 CR3d 303, 310-311—noting there is *no general alter ego claim* by which shareholders may be held personally liable for bankrupt corporation's debts (alter ego theory designed to avert injustice *in facts of particular case*; *see ¶ 2:52.1*); *Stodd v. Goldberger* (1977) 73 CA3d 827, 833, 141 CR 67, 71-72; *Ahcom, Ltd. v. Smeding* (9th Cir. 2010) 623 F3d 1248, 1251-1252 (applying Calif. law)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cross-refer: For a more detailed discussion of this topic, see March & Shapiro, *Cal. Prac. Guide: Bankruptcy* (TRG), Chs. 6 & 8 Part I.

(10) [2:57.6] **No "reverse piercing" by controlling shareholder's creditors to obtain corporate assets:** A shareholder's personal creditors cannot reach the corporation's assets by holding the corporation liable as the *shareholder's alter ego*. This is so even where a controlling shareholder transferred personal assets to the corporation for the express purpose of thwarting creditors. California follows the weight of authority in rejecting the "reverse piercing" theory on the grounds that it:

• Bypasses normal collection procedures whereby the shareholder's judgment creditors attach the shareholder's *shares* in the corporation and not the corporation's assets;

• Prejudices the corporation's other innocent shareholders; and

• Is unnecessary, since more traditional theories—such as conversion, fraudulent conveyance, respondeat superior and agency law—adequately allow recovery, where appropriate, against a corporation for a controlling shareholder's wrongful conduct. [*Postal Instant Press, Inc. v. Kaswa Corp.* (2008) 162 CA4th 1510, 1518-1524, 77 CR3d 96, 101-106; see *Cascade Energy & Metals Corp. v. Banks* (10th Cir. 1990) 896 F2d 1557, 1577 (abrogation on other grounds recognized by *Banner Bank v. Smith* (2022) 30 F4th 1232, 1241)]

(a) [2:57.6a] **Exception—federal tax liabilities:** Many courts have permitted the United States to recover a taxpayer's delinquent tax liability from the taxpayer's alter ego business entity. "These cases recognize that reverse piercing is a well-established theory in the federal tax realm that advances the policies of avoiding fraud and collecting delinquent federal taxes." [*Postal Instant Press, Inc. v. Kaswa Corp.* (2008) 162 CA4th 1510, 1522, 77 CR3d 96, 104, fn. 3 (internal quotes omitted); see *Towe Antique Ford Found. v. I.R.S.* (9th Cir. 1993) 999 F2d 1387, 1390-1391]

[2:57.6b - 2:57.6d] ***Reserved.***

(b) [2:57.6e] **Compare—LLC:** "Reverse piercing" may be available to allow a creditor of an LLC member to reach the LLC's assets where there are no innocent LLC members who would be prejudiced thereby. Although this ground could appear to apply also with respect to a corporation where no innocent shareholders would be prejudiced by reverse piercing, an LLC is different: The creditor's remedies ordinarily are limited to a charging order against distributions to the member (Corps.C. § 17705.03), and the debtor remains an LLC member with the right to manage and control the LLC, including the right to make—or not make—distributions. Where an LLC member has consistently evaded its obligations to a creditor, allowing reverse piercing would provide the creditor with a more viable remedy than traditional collection procedures. [*Curci Investments, LLC v. Baldwin* (2017) 14 CA5th 214, 222-224, 221 CR3d 847, 852-853 (husband and wife debtors who held all membership interests of LLC formed as vehicle for holding and investing debtor's money evaded creditor for 5 years); *Blizzard Energy, Inc. v. Schaefers* (2021) 71 CA5th 832, 846-847, 286 CR3d 658, 669-670—charging order against distributions to LLC member is not judgment creditor's exclusive remedy (Corps.C. § 17705.03 "does not preclude reverse veil piercing to add the LLC as a judgment debtor"); for further discussion, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 6]

(11) [2:57.7] **No shareholder piercing to obtain corporate assets:** The purpose of the alter ego doctrine is to permit *third party creditors* to enforce corporate debts *against shareholders* who disregarded the separate existence of the corporation. The doctrine *cannot* be invoked *by shareholders* as a device to obtain the corporation's assets. [See *Communist Party of U.S.A. v. 522 Valencia, Inc.* (1995) 35 CA4th 980, 993-995, 41 CR2d 618, 625-627—alter ego doctrine cannot be used to transfer assets of public benefit corporation to political party purporting to be corporation's "controlling force" and intended beneficiary]

(a) [2:57.8] **No "equitable" right to corporate assets for purpose of claiming bankruptcy exemption:** Similarly, an individual shareholder in bankruptcy does *not* have an "equitable" interest in corporate assets that would enable the shareholder to claim any of those assets (e.g., a corporate automobile) as property *of the shareholder* eligible for a bankruptcy *exemption*. This is so even where the debtor is the corporation's *sole* shareholder. [See 11 USC § 541(a)(1) (debtor's estate includes all legal *or equitable* interests in property as of commencement of bankruptcy case); *Fowler*

v. Shadel (7th Cir. 2005) 400 F3d 1016, 1018-1019; also see CCP § 703.140 (exempt property in federal bankruptcy proceedings)]

(12) [2:57.9] **No shareholder piercing to obtain corporation's insurance coverage:** Similarly, shareholders cannot invoke the alter ego doctrine to obtain the status of "insureds" under policies naming only the corporation as the insured. [*Seretti v. Superior Nat'l Ins. Co.* (1999) 71 CA4th 920, 931, 84 CR2d 315, 322; see *D. Cummins Corp. v. United States Fidelity & Guaranty Co.* (2016) 246 CA4th 1484, 1491-1492, 201 CR3d 585, 591-592—parent of insured subsidiary lacked standing to join in subsidiary's declaratory relief action against insurer]

(13) [2:57.10] **No shareholder piercing to use corporation's contractor's license:** Nor can a shareholder—or the shareholder's sole proprietorship—invoke the alter ego doctrine to utilize a contractor's license held by a corporation wholly owned by the shareholder. The alter ego doctrine was founded on equitable principles to prevent an injustice; it may not be used to allow a crafty individual to circumvent state licensing requirements. [*Twenty-Nine Palms Enterprises Corp. v. Bardos* (2012) 210 CA4th 1435, 1450-1452, 149 CR3d 52, 65-66]

(14) [2:57.11] **Distinguish—jurisdiction over foreign parent based on subsidiary's California activities:** Courts have employed various legal theories to determine whether the presence or activities of a corporation (or other business entity) doing business in California may allow a California court to assert jurisdiction over the corporation's out-of-state parent corporation.

(a) [2:57.11a] **Federal constitutional test:** California courts may exercise jurisdiction to the full extent permitted by the U.S. Constitution. [CCP § 410.10; see *Williams v. Yamaha Motor Co. Ltd.* (9th Cir. 2017) 851 F3d 1015, 1020]

Under federal law, a California court's jurisdiction over a foreign parent arising from its subsidiary's California presence may be either "general" or "specific":

1) [2:57.11b] **"General" jurisdiction:** General or "all-purpose" jurisdiction exists when the parent corporation's contacts with California are so *constant and pervasive* as to render it "essentially at home" in California. In such circumstances, a California court has jurisdiction to adjudicate *any and all claims* against the foreign parent—i.e., even where the claim is *unrelated to the activities of the parent or its subsidiary operating in California*. (E.g., California court may assert jurisdiction over Nevada parent based on California subsidiary *with respect to tort committed in Arizona by another subsidiary*.) [*Daimler AG v. Bauman* (2014) 571 US 117, 121-122, 134 S.Ct. 746, 751—German parent corporation's contacts with California through marketing activities of Delaware subsidiary doing business in California insufficient to establish general jurisdiction over parent for alleged human rights violations committed in Argentina by parent's Argentine subsidiary; *Young v. Daimler AG* (2014) 228 CA4th 855, 859, 864-866, 175 CR3d 811, 813, 817-820 & fn. 2—California contacts insufficient to establish jurisdiction over German parent with respect to accident occurring in California involving vehicle manufactured by Delaware subsidiary doing business in California; *Williams v. Yamaha Motor Co. Ltd.* (9th Cir. 2017) 851 F3d 1015, 1021-1022—California contacts insufficient to establish jurisdiction over Japanese parent with respect to allegedly defective outboard motors manufactured by parent in Japan and marketed by subsidiary in California; see *Bristol-Myers Squibb Co. v. Superior Court of Calif., San Francisco County* (2017) 582 US 255, 262, 137 S.Ct. 1773, 1780]

General jurisdiction over large multi-state or multi-national parents is rare: "A corporation that operates in many places can scarcely be deemed at home in all of them." [*Daimler AG v. Bauman*, supra, 571 US at 139, 134 S.Ct. at 762, fn. 20]

2) [2:57.11c] **"Specific" jurisdiction:** Specific or "conduct-linked" jurisdiction over a foreign parent may be established upon the commission of a single act or occasional acts of the parent through its subsidiary operating in California in a case arising *out of that in-state activity*. [*Daimler AG v. Bauman* (2014) 571 US 117, 127, 134 S.Ct. 746, 754; see *Young v. Daimler AG* (2014) 228 CA4th 855, 864, 175 CR3d 811, 817 & fn. 5 —in product liability action arising from accident in California involving vehicle designed and manufactured in U.S. and distributed in California by Delaware subsidiary, no specific jurisdiction over German parent that was not involved in vehicle's design, manufacture or distribution; see also *Bristol-Myers Squibb Co. v. Superior Court of Calif., San Francisco County* (2017) 582 US 255, 262-264, 137 S.Ct. 1773, 1780-1781]

[2:57.11d - 2:57.11g] *Reserved.*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) [2:57.11h] **Subsidiary as parent's agent:** A number of courts have asserted jurisdiction over a foreign parent that exercised such pervasive and continual control over the California subsidiary as to render the subsidiary nothing more than a mere instrumentality or agency of the parent.

However, for jurisdiction to attach on an agency theory, plaintiff must show the parent went beyond a parent's normal role of setting policy and direction for the subsidiary's activities. Plaintiff must show the parent *purposely disregarded the subsidiary's independent corporate existence, taking over performance of the subsidiary's day-to-day operations* so that, in effect, the subsidiary is nothing more than an *incorporated department* of the parent. [*Sonora Diamond Corp. v. Sup.Ct. (Sonora Union High School Dist.)* (2000) 83 CA4th 523, 539-550, 99 CR2d 824, 837-845; *Dorel Indus., Inc. v. Sup.Ct. (Jackson)* (2005) 134 CA4th 1267, 1275-1276, 36 CR3d 742, 749-750; *F. Hoffman-La Roche, Ltd. v. Sup.Ct. (Wertheimer)* (2005) 130 CA4th 782, 797-805, 30 CR3d 407, 418-425]

1) [2:57.11i] **"Representative services" as variant of agency:** Under the "representative services" doctrine, a foreign parent may become subject to jurisdiction in a state in which its subsidiary assists the parent in pursuit of the *parent's own business*. Here, plaintiff must show the subsidiary essentially exists only to further the parent's business, and *but for the subsidiary's existence*, the parent *would be performing these functions itself* in the state. [*Dorel Indus., Inc. v. Sup.Ct. (Jackson)* (2005) 134 CA4th 1267, 1277-1280, 36 CR3d 742, 750-753; *F. Hoffman-La Roche, Ltd. v. Sup.Ct. (Wertheimer)* (2005) 130 CA4th 782, 798, 30 CR3d 407, 419; *In re Automobile Antitrust Cases I & II* (2005) 135 CA4th 100, 119, 37 CR3d 258, 276]

2) [2:57.11j] **Continued viability of agency and "representative services" doctrines?** The continuing validity of the agency and "representative services" doctrines has been cast into doubt by the Supreme Court's decision in *Daimler AG v. Bauman*, supra (¶ 2:57.11b ff.). [See *Daimler AG v. Bauman* (2014) 571 US 117, 133-135, 134 S.Ct. 746, 758-760; also see *Young v. Daimler AG* (2014) 228 CA4th 855, 866-867, 175 CR3d 811, 819—"the specifics of the agency test applied are irrelevant to the *Bauman* holding, as the result would be the same under *any* theory of agency" (emphasis in original); and *Williams v. Yamaha Motor Co. Ltd.* (9th Cir. 2017) 851 F3d 1015, 1023-1024—*Daimler AG* "voided" agency test re general jurisdiction and cast doubt re specific jurisdiction]

3) [2:57.12] **Alter ego doctrine contrasted:** The agency approach for jurisdictional purposes is similar to an alter ego analysis in that both require a showing of the parent's *intentional disregard of the subsidiary's independent existence*. However, the agency approach does *not* require the elements of wrongdoing and resulting injustice necessary to establish alter ego liability (¶ 2:52.1). [*Sonora Diamond Corp. v. Sup.Ct. (Sonora Union High School Dist.)* (2000) 83 CA4th 523, 541, 99 CR2d 824, 838; see *F. Hoffman-La Roche, Ltd. v. Sup.Ct. (Wertheimer)* (2005) 130 CA4th 782, 798, 30 CR3d 407, 419]

(c) [2:57.13] **"Purposeful availment":** Foreshadowing the Supreme Court's decision in *Daimler AG v. Bauman*, supra (¶ 2:57.11b ff.), several California decisions criticized use of the agency, "representative services" and alter ego doctrines as inappropriately invoking rules of law designed to establish *liability* for the acts of another. "The proper jurisdictional question is not whether the defendant can be liable for the acts of another person or entity under state substantive law, but whether the defendant has purposefully directed its activities at the forum state by causing a separate person or entity to engage in forum contacts." These cases concluded, "[a] parent company purposefully avails itself of forum benefits through the activities of its subsidiary, as required to justify the exercise of specific personal jurisdiction, *if and only if the parent deliberately directs the subsidiary's activities in, or having a substantial connection with, the forum state*." [*HealthMarkets, Inc. v. Sup.Ct. (Berman)* (2009) 171 CA4th 1160, 1169-1170, 90 CR3d 527, 534-535 (emphasis added); *BBA Aviation PLC v. Sup.Ct. (Engen)* (2010) 190 CA4th 421, 435-437, 117 CR3d 914, 926-928; *Anglo Irish Bank Corp., PLC v. Sup.Ct. (Brar)* (2008) 165 CA4th 969, 983, 81 CR3d 535, 547 & fn. 13]

Cross-refer: The exercise of "general" and "specific" jurisdiction over foreign corporations is discussed in greater detail in Stevenson & Fitzgerald, *Rutter Group Prac. Guide: Fed. Civ. Pro. Before Trial* (TRG), Ch. 3; and Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 3.

[2:57.14 - 2:57.15] ***Reserved.***

(15) [2:57.16] **Cross-refer—personal liability under common law and federal and state statutes:** Notwithstanding the corporate (or other business) entity, individual shareholders—particularly those who are also directors, officers or corporate

employees—may be personally liable under the common law for their own tortious conduct and under various state and federal statutes for their direct participation in (or control over) prohibited activities. *See discussion in Ch. 6.*

d. [2:58] **Impact:** While avoidance of personal liability for business debts is a distinct advantage of the corporate form, the advantage is more theoretic than real. As shown above (¶ 2:48 ff.), the advantage is usually restricted to *uninsured* tort claims, and claims by creditors who were willing to rely on the corporation's credit without shareholder guaranties. And, even in such cases, personal liability can still be fastened on the shareholders if there are grounds for "piercing" the corporate veil or if the shareholders directly authorized or participated in corporate wrongdoing. Therefore, avoiding personal liability for business debts or liabilities is frequently *not* a determinative factor in deciding whether to incorporate a new or small business venture.

2. [2:59] **Continuity:** At one time, a major consideration in choosing the form of entity was the effect on the business of a principal's death or withdrawal (or bankruptcy, etc.). Under prior law, a principal's death or withdrawal could automatically dissolve a partnership; thus, the corporation, whose existence continued independently of its shareholders, enjoyed a considerable advantage.

Under current *general partnership* law, a general partner's death or withdrawal may cause a "dissociation" (triggering a buy-out of the partner's interest) or even dissolution of the partnership, but the partnership agreement can be drafted to avoid these consequences. Under *limited partnership* law, a general partner's death or withdrawal will *not* dissolve the limited partnership if at least one remaining general partner continues the business or, where there is no remaining general partner, the limited partners admit a new general partner. *See¶ 2:21a ff., 2:35*.

An LLC automatically terminates upon a member's death or withdrawal only if the articles of organization or written operating agreement expressly so provides (*see¶ 2:36.22*). Absent such provision, the LLC continues indefinitely.

Thus, a partnership and LLC can have essentially the same continuity of existence as a corporation.

• [2:60] **Comment:** In some cases, the death or retirement of one of the principals may make it economically impractical for the business to continue. In such cases, the legal continuity of the form of business chosen is irrelevant.

➪ [2:61] ***PRACTICE POINTER:*** Some sort of buy-sell agreement among the principals is advisable regardless of the type of entity selected (¶ 3:187).

[2:62] ***Reserved.***

3. [2:63] **Transferability of Interests:** Absent restrictions imposed by agreement or securities laws (¶ 2:64 ff.), shares of corporate stock are freely transferable. In contrast, partnership and LLC interests are not: The right to receive distributions can be assigned, but unless the partnership agreement or LLC operating agreement expressly so provides, no one can be substituted as a partner or member without the consent of all other general partners (and a majority in interest of any other limited partners) or all of the other LLC members. [Corps.C. §§ 15907.01, 15907.02(a)(3), 16502, 16503(a)(2), (b); Corps.C. §§ 17704.01(c), 17705.02(a), (b)]

a. [2:64] **Agreements restricting transfer of corporate shares:** But in closely-held corporations, the shareholders usually enter into agreements *restricting* their right to transfer their shares to others (e.g., "buy-sell" provisions; or right of first refusal provisions).

b. [2:65] **Securities law restrictions applicable to corporate shares:** Moreover, there is a very limited market for shares of a closely-held corporation, and their transfer is often subject to federal and state securities law restrictions (*see Ch. 5*).

c. [2:66] **Impact:** On balance, transferability of ownership interests is usually *not* a major factor for a closely-held business in choosing among a partnership, LLC or corporation.

4. [2:67] **Management and Control:** If the principals all want to have a say in the operation of the business, the choice should be either a corporation, LLC or general partnership. (Limited partners normally may not participate in control of the partnership business without risking personal liability for the partnership debts; *see¶ 2:27*.)

a. [2:68] **Advantages of corporate form:** A corporation has a highly centralized structure for management and control: Its shareholders elect its directors, who appoint the officers who run the business. And, the directors and officers need not be shareholders. Thus, where some of the owners are not going to be active in management (or persons who are *not* owners are to be given management powers), a corporation would be the preferred form of organization.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b. [2:69] **Compare—partnerships:** In contrast, management of a general partnership business requires a great deal of "getting along," as the majority rules in the absence of agreement to the contrary (*see*¶ *2:18*). Further, despite any agreement among the partners limiting authority, each is treated as the agent of the partnership in dealings with third persons (unless such third person knew or received notification of the limitation on such partner's authority). [Corps.C. § 16301(1)]

c. [2:69.1] **Compare—LLCs:** An LLC's articles can provide for managers (who need not be members, ¶ *2:36.16*) and thus achieve centralized management. In a manager-managed LLC, only the managers have authority to bind the LLC. [Corps.C. § 17703.01(b)]

Unless the articles indicate that the LLC is managed by one or more managers, an LLC is managed by *all* its members (¶ *2:36.10*), with members voting in proportion to their respective interests in current profits (unless a different voting scheme is set forth in the articles or written operating agreement). Where the LLC is managed by all its members, each is treated as the agent of the company in dealings with third persons (¶ *2:36.14*). [Corps.C. §§ 17703.01(a), 17704.07(a), (b), (r)]

d. [2:70] **Impact:** Where all of the owners wish to have a say in the conduct of the business, but wish to avoid investing each other with the power to bind them personally, the corporate form (or an LLC with centralized management, ¶ 2:69.1) is the obvious choice.

[2:71] ***Reserved.***

5. Cost Considerations

a. Formation costs

[2:72] Minimum costs of forming a California corporation include:

•	Filing fee to Secretary of State.........	$100
•	Corporate supplies (seal, minute book, etc.).........	approx. $75
•	Filing fee to Department of Financial Protection and Innovation for notice of transaction under § 25102(f) or (h)......... (if qualification required, filing fee is $200 plus 1/5th of 1% of offering price (maximum $2,500); see Corps.C. § 25608)	minimum $25
	Total	$400

[2:73] No such fees are involved in forming a general partnership or sole proprietorship.

(1) [2:74] **Compare—limited partnership and LLC:** A limited partnership must file a *certificate* of limited partnership (*see*¶ *2:34*), and an LLC must file *articles of organization* (*see*¶ *2:36.30*), with the Secretary of State. The $70 filing fee for the certificate or articles is somewhat less than the $100 fee for filing corporate articles. [Gov.C. §§ 12186(c), 12188(b), 12190(b)]

Limited partnerships (including LLPs) and LLCs that register on or after January 1, 2021, and before January 1, 2024, are not required to pay a minimum franchise tax (¶ 2:97.1 ff., 2:97.22 ff., 2:321 ff.) in their *first* taxable year. [Rev. & Tax.C. §§ 17935(f)(1), 17941(g)(1), 17948(e)(1); *see also*¶ 2:102.2 ff.]

(2) [2:75] **Fictitious business name filing:** Also, a proprietorship or partnership (or any other entity) doing business under a *fictitious name* is required to file with the county clerk and publish a fictitious business name statement; *see* ¶ *2:8*.

b. [2:76] **Legal fees:** The fees charged by the attorney will vary, of course, with the amount of work required. Normally, the sole proprietorship will require the least legal work and thus will be the least expensive.

A partnership or LLC may or may not require less legal work than forming a corporation. Costs vary considerably in preparing the governing documents of partnerships or LLCs and in preparing shareholders agreements. Legal fees can be substantial where there are many partners, members or shareholders, or where the agreements are heavily negotiated.

Following the initial formation, a corporation is likely to require greater attorney involvement (e.g., conducting periodic director and shareholder meetings, preparing minutes, etc.), thus ultimately giving rise to higher legal fees than a partnership or LLC.

c. [2:77] **Accounting fees:** Fees for corporate accounting and corporate tax returns can be greater than those charged to a sole proprietor, partnership or LLC. The reason is that a corporation is a tax*paying* entity, whereas an unincorporated business is not. (Partnerships and LLCs are required to file informational returns, but they do not pay taxes as an entity, except for the $800 minimum franchise taxes (¶ 2:97.1, 2:97.22) and—for LLCs—an annual fee on total income (¶ 2:97.23).)

d. [2:78] **Payroll taxes:** General partners, LLC members who participate in management and sole proprietors do not pay social security taxes. Instead, they pay self-employment taxes. [See IRC § 1401]

If the business is incorporated and salaries are paid to the principals, the corporate employer and the employees both pay social security taxes.

The self-employment tax is currently 15.30% (an employer and an employee would each pay 7.65%). This is equal to the combined social security payroll tax (12.4%, payable on the first $168,600 of net earnings) and Medicare payroll tax (2.9%, payable on entire net earnings). [IRC § 1401(a), (b)(1)] Individuals earning more than $200,000 and couples earning more than $250,000 pay an additional 0.9% Medicare self-employment (or payroll) tax. [IRC § 1401(b)(2)(A)]

6. [2:79] **Other Considerations:** Other factors sometimes taken into account in choosing the business entity are simplicity of operation and anonymity of ownership.

a. [2:80] **Simplicity of operation:** Much less formality is involved in operating as a partnership or LLC than in conducting business in the corporate form. A corporation is required to have a board of directors, corporate officers, annual shareholder meetings, and to maintain separate books and records, etc. Failure to observe such formalities may expose the principals to personal liability for the corporation's debts (*see*¶ *2:52*).

b. [2:81] **Anonymity of ownership:** In general, the corporate form best assures privacy and anonymity of ownership. While a corporation is required to file a biennial statement with the California Secretary of State disclosing its officers and directors, there is no requirement for disclosure of *shareholder* identities. [See Corps.C. § 1502]

(1) [2:81.1] **Compare—federal FinCEN reporting requirements:** Pursuant to the federal Corporate Transparency Act (CTA), commencing January 1, 2024, corporations (as well as limited liability companies and other entities created by filing a document with a Secretary of State or similar U.S. office) doing business in the United States are required (unless exempt) to register "beneficial ownership information" (BOI) with the United States Treasury Department's Financial Crimes Enforcement Network (FinCEN). The BOI filed with FinCEN is not subject to public disclosure under a Sunshine Act request, but it will be accessible by state and local law enforcement agencies in certain circumstances. [See 31 USC § 5336; 31 CFR 1010.380; *see*¶ 4:531 ff.]

(2) [2:82] **Compare—general partnership:** Partners in a general partnership may be compelled to disclose their identities in certain situations: e.g., if the partnership engages in business under a fictitious name, a certificate showing the names of all partners must be filed with the county clerk and published in a local newspaper (¶ *2:8*); business licenses commonly require disclosure of all partners; and if the partnership wishes to take title to property in the partnership name, a statement of partnership will have to be recorded by at least two of the partners. [Corps.C. §§ 16105(b), (c), 16303]

(3) [2:83] **Compare—limited partnership:** A limited partnership is similar to a corporation in that the certificate of limited partnership need *not* disclose the names of the limited partners, nor the amounts of their investments (*see*¶ *2:34.1*).

(4) [2:83.1] **Compare—LLC:** An LLC is also similar to a corporation in that the articles of organization need not disclose the names of the members or even the managers, or the amount of the members' investments (*see*¶ *2:36.31*). [Corps.C. § 17702.01(b)] However, an LLC must file a *biennial statement* disclosing its managers (and chief executive officer, if any); and if no manager has been designated, the biennial statement must also disclose the names and addresses of *all* members. [Corps.C. § 17702.09(a)(5)]

Cross-refer: For a comprehensive discussion of choice of entity from the point of view of pass-through entities (general partnerships, limited partnerships, LLPs and LLCs), see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 2.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 2-C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 2. Substantive Law Considerations in Choosing Business Entity: Tax and Nontax Factors

C. Comparison of Tax Consequences

- 1. [2:85] Taxation of Business Income
  - a. [2:85.1] Overview of federal legislation
    - (1) [2:85.2] Corporate rates
    - (2) [2:85.3] Individual (personal) rates
    - (3) [2:85.4] Owners of pass-through entities
  - b. [2:85.10] California tax law
  - c. [2:86] Pass-through entities (sole proprietorship, partnership, LLC)
    - (1) [2:86.1] Disadvantages if earnings retained
    - (2) [2:87] Advantages if losses contemplated
      - (a) [2:87.1] Limitation on "passive activity" losses
        - 1) [2:87.2] Three categories of income or loss
        - 2) [2:87.3] Deductibility of active and passive losses
          - a) [2:87.4] Effect
          - b) [2:87.4a] Passive activity losses deductible in future years
        - 3) [2:87.5] Tests for "material participation"
          - a) [2:87.6] General "facts and circumstances" test
          - b) [2:87.7] Six "quantitative" tests under IRS Regs.
          - c) [2:87.7a] "Grouped" activities
            - 1/ [2:87.7b] Limitations
          - d) [2:87.7c] Capacity in which taxpayer participates immaterial
          - e) [2:87.7d] Spouse's participation included
          - f) [2:87.7e] Ways to document participation
        - 4) [2:87.8] Rental activities subject to more stringent standard
          - a) [2:87.8a] "Rental activities" defined
          - b) [2:87.9] Exception—$25,000 offset for losses from rental real estate
            - 1/ [2:87.10] "Active participation"
        - 5) [2:87.11] Limitations cease upon disposition of interest in "passive activity"
          - a) [2:87.12] Not applicable to tax-free exchange
      - (b) [2:87.21] Limitation on excess business losses
        - 1) [2:87.22] Excess business loss threshold
        - 2) [2:87.23] Application to partnerships and S corporations
        - 3) [2:87.24] Limitation on NOL carryovers

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

4) [2:87.25] NOLs after 2017
(3) [2:88] 20% deduction for "qualified business income" (QBI)
(a) [2:88.1] QBI defined
1) [2:88.2] Exclusions
(b) [2:88.3] Applicable pass-through entities
(c) [2:88.4] Wage and capital limitation
1) [2:88.4a] "W-2 wages" defined
(d) [2:88.5] Disallowance for certain service businesses "specified service trade or business"
1) [2:88.5a] Engineering and architecture excepted
2) [2:88.5b] "De minimus" exception for combined trade/service business
(e) [2:88.6] Effect of phase-ins
(f) Examples
1) [2:88.7] Taxable income below threshold amount
2) [2:88.8] Taxable income above threshold amount and no specified service business
(4) [2:89] Special considerations re partnerships
(a) [2:90] Profits and losses "passed through" to partners
(b) [2:91] Advantage for tax-sheltering
1) [2:92] Special advantage for real estate limited partnerships
2) [2:93] Compare—corporations
(c) [2:93.1] Compare—"publicly traded" partnerships
(d) "Passive activity" loss limitations
1) [2:93.2] General partners
2) [2:93.4] Limited partners presumed passive
a) [2:93.5] Exceptions—material participation by limited partners
b) [2:93.5e] Not applicable to LLC members
3) [2:93.6] Compare—"publicly traded" partnerships
a) [2:93.7] Compare—"non-passive" publicly traded partnerships
(e) [2:95] Fiscal year
1) [2:96] "Business purpose" deferral rule
2) [2:96.1] Three-month deferral election
(f) [2:97] Tax audits at partnership level
(g) [2:97.1] Minimum franchise tax on limited partnerships
1) [2:97.2] First-year exemption
2) [2:97.3] Compare—general partnerships
(5) [2:97.5] Special considerations re limited liability companies
(a) [2:97.18] Applicability of partnership taxation provisions to LLCs
1) [2:97.19] Exception—greater opportunity for leveraged basis than in limited partnership
a) [2:97.20] Effect of debt on member's basis
b) [2:97.21] Compare—effect of debt on limited partner's basis
(b) California tax treatment of LLC
1) [2:97.22] Minimum franchise tax on LLCs
a) [2:97.22a] First-year exemption
b) [2:97.22b] Exemption for small business LLCs owned by deployed armed forces member
2) [2:97.23] Additional "fee"
(6) [2:98] Taxation of individuals
(a) [2:99] Ordinary income rate structure
1) [2:100] 3.8% surtax on dividends and other "investment income"
(b) [2:100.1] Capital gain rates—ordinarily, 20% maximum

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [2:100.2] Exclusion of gain from "small business stock"
1) [2:100.3] Qualifying criteria for "small business stock"
2) [2:100.4] Limitations on exclusion of gain
3) [2:100.5] Certain "tax-free" stock transfers permitted
4) [2:100.6] Rollover of potential capital gain on sale of stock
(d) [2:100.11] Alternative minimum tax (AMT)
1) [2:100.12] AMT income amounts (exemptions)
2) [2:100.13] Items included in AMT
d. [2:101] Corporation
(1) Corporate tax rates
(a) [2:102] 21% flat federal rate
1) [2:102.1] Corporate alternative minimum tax (AMT)
(b) [2:102.2] State franchise tax
1) [2:102.3] First year exemption from minimum tax
2) [2:102.4] Exemption for certain corporations owned by deployed armed forces member
(c) [2:102.5] Compare—individual vs. corporate taxes
(2) [2:103] Double taxation where dividends paid
(a) [2:104] Risk of penalty tax if dividends withheld
(3) [2:105] Compare—tax-deductible payments to shareholders
(a) [2:106] Limitation—"reasonable" business expenses
1) [2:106.1] Factors determinative of "reasonable" compensation
a) [2:106.2] "Independent investor's expected return"
2) [2:107.1] Caution—compensation allocated on basis of stock ownership (disguised dividend treatment)
3) [2:107.5] Effect of repayment agreements
(b) [2:108] Interest on debt owed to shareholders
1) [2:108.1] Market interest rate
2) [2:108.2] Caution—excessive debt
(4) [2:109] Retention of profits by corporation
(a) [2:110] Penalty tax on personal holding company income
1) [2:111] When applicable
2) [2:112] Avoiding penalty
(b) [2:113] Penalty tax on "unreasonable" accumulations of earnings
(5) [2:114] Deferral of income possibilities
(a) [2:115] Dividend payment dates
(b) [2:116] Accruing expense payments to shareholders
1) [2:117] Example
2) [2:118] Limitation
(c) [2:118a] Certain corporations precluded from using cash basis accounting
(6) [2:118.1] Double taxation on liquidating distributions
(a) [2:118.2] Example
(b) [2:118.2f] Distinguish—sale of stock
(7) [2:118.3] "Passive activity" loss limitations
(a) [2:118.4] Application to closely-held corporations
1) [2:118.5] Deductibility of "passive activity" losses
a) [2:118.6] Example
2) [2:118.9] "Material participation" in activity—losses fully deductible
3) [2:118.10] Two tests for "material participation"
a) [2:118.11] "Material participation" by majority shareholders

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b) [2:118.12] Employee participation in activity
4) [2:118.13] Special rules for "rental activities"
(b) [2:118.14] Application to "personal service corporations"
1) [2:118.15] Deductibility of "passive activity" losses
2) [2:118.16] "Material participation"
e. [2:119] S corporations
(1) [2:121] Advantages over regular corporation
(a) [2:122] Losses "passed through" to shareholders
1) [2:122.1] Tax planning
2) [2:123] "Passive activity" loss limitation
3) [2:124] Basis limitation on loss write-offs
a) [2:124a] Requirements for loans
b) [2:124.1] Shareholder "guaranty" of S corporation loans to increase basis
1/ [2:124.2] Compare—bona fide loan using third party funds
2/ [2:124.3] Limitation—loans from other shareholders excluded from basis
c) [2:125e] Third-party loan secured by shareholder's property
1/ [2:125f] Pledge of S corporation stock
4) [2:125.1] No loss carryovers between C and S years
5) [2:125.5] Section 1244 not available to S corporation as shareholder
(b) [2:126] Profits taxable at individual shareholder rates
1) [2:126.1] Income taxed whether or not distributed
a) [2:126.1a] Income taxed to beneficial owner
2) [2:126.1e] Exception for former C corporations with passive income
a) [2:126.1f] Distinguish—dividends received from subsidiary
3) [2:126.2] Potential 20% deduction for "qualified business income"
4) [2:126.3] S and C corporations compared
(c) [2:127] Safe method for distribution of profits
1) [2:128] Limitation—no avoidance of employment taxes
(d) [2:128.1] Avoid "double tax" on liquidating sale or distribution of corporate assets
1) [2:128.2] Caution—converting from C to S status
(e) [2:129] "Passive income"; limitations
(f) [2:130] Treatment of subsidiaries
1) [2:130.1] S corporation subsidiary
a) [2:130.2] Termination of election
b) [2:130.3] Caution—no "partial" S corporation subsidiary
2) [2:130.4] C corporation subsidiary
(g) [2:130.10] Compare—no deduction for dividends received
(h) [2:131] Compare—limitation on certain fringe benefits
(i) [2:132] *Caution*—gain/loss on property contributed by shareholder and later sold by corporation
(2) [2:134] S corporation compared to partnership and LLC
(a) [2:135] S corporation advantageous as investment vehicle
1) [2:137] No personal liability for business debts
2) [2:138] Continuity
3) [2:138.1] Transferability
4) [2:138.2] One shareholder permitted
5) [2:139] Management and control
(b) [2:140] Partnership or LLC advantageous for loss write-offs
(c) [2:141] Partnership or LLC advantageous for allocating profits and losses
(d) [2:141.1] Partnership and LLC avoidance of S corporation restrictions

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(3) [2:142] Requirements for S status
(a) [2:143] No more than 100 shareholders
1) [2:144] Kinds of shareholders
2) [2:144a] Spouses and family members treated as one shareholder
3) [2:144.1] Partnership composed of S corporations can avoid shareholder limit
(b) [2:145] Single class of stock (except as to voting rights)
1) [2:146] Restrictions on certain shares may be deemed to create second class of stock
2) [2:147] Certain debt instruments may be treated as second class of stock
(c) [2:148] Timely election required
1) [2:149] When taxable year begins
a) [2:149.1] Compare—"taxable year" for tax reporting purposes
2) [2:149.2] Shareholder consents required
(4) [2:150] Fiscal year for S corporations
(a) [2:151] Three-month deferral election
(5) [2:152] Termination of S status
(a) [2:153] Revocation of election
1) [2:153.1] Effective date
(b) [2:154] Disqualification as S corporation
1) [2:155] When effective
2) [2:156] Ban on renewed election; reinstatement following inadvertent termination
2. [2:157] Taxation of Transfers to Business Entity
a. [2:158] Partnerships and LLCs
(1) [2:158.1] Compare—interests granted for services rendered
(a) [2:158.4] Potential capital gain treatment
b. [2:159] Corporations
c. [2:160] Requirements for tax-free incorporation (IRC § 351)
(1) [2:161] "Property"
(a) [2:162] Compare—taxation of services
(2) [2:163] "Solely for stock"
(a) [2:164] Taxable "boot"
(b) [2:165] Assumption of liabilities as "boot"
(3) [2:166] "Control"
(4) [2:167] Planning considerations
(5) [2:168] Compare—*conversion* into corporation
d. [2:171] Compare—taxation of services contributed to new business
(1) [2:172] Effect
(2) [2:173.5] Deduction by corporation
(a) [2:173.6] Corporation bound by amount included in recipient's income?
1) [2:173.7] "Safe harbor" for corporate deduction
(3) [2:174] Deferral of tax
(a) [2:175] Application—"earnout" restriction
1) [2:175.1] Example
(b) [2:175.2] What constitutes receipt "in connection with performance of services"
(c) Planning considerations
1) [2:176] Recipient's election to treat as current income
2) [2:177.1] Nature of forfeiture condition
a) [2:177.1a] Limitation—significant shareholder
b) [2:177.2] Relationship of forfeiture to share price
3) [2:177.3] Gradual vesting of ownership

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [2:177.4] Example
4) [2:177.4a] Election to further defer recognition
a) [2:177.4b] Potential 5-year deferral
b) [2:177.4c] "Eligible corporation"
e. Compare—other taxes
(1) [2:177.5] State sales tax
(a) [2:177.5a] Contributions to commencing corporations
(2) [2:177.6] Real property taxes
(a) [2:177.7] Structuring initial transfer to avoid reassessment
1) [2:177.7f] Similar rule re documentary transfer tax
(b) [2:177.8] Reassessment upon subsequent transfer of stock, LLC interests or partnership interests
1) [2:177.9] Filing "change in ownership statement" required
2) [2:177.10] Documentary transfer tax
3. [2:178] Taxation on Disposing of Investment
a. [2:179] Capital gains
(1) [2:179.1] Importance of distinction between capital gains and ordinary income
(2) [2:180] Tax planning
b. Losses
(1) [2:183] Business losses
(2) [2:184] Losses on investment
(a) [2:185] Proprietorship
(b) [2:186] Partnerships and LLCs
(c) [2:187] Corporations
1) [2:188] Ordinary loss on § 1244 stock
a) [2:189] "Small business corporation"
b) [2:190] Any class of stock
c) [2:191] Issued for cash or property
1/ [2:191.1] Caution re additional capital contributions
d) [2:192] Initial purchasers
e) [2:193] Written plan not required
4. [2:196] Deductibility of Organizational Expenses
a. [2:196.1] Organizational expenses for corporations
b. [2:196.2] No amortization until business begins
5. [2:197] Fringe Benefits
a. [2:215] Group term life insurance
b. [2:216] Health insurance; medical expense reimbursement plans
c. [2:219] Employee "incentive stock options"
(1) [2:221] Employee requirements
(a) [2:221.1] Leave of absence allowed
(b) [2:221.2] Permitted transfers during holding period
(c) [2:222] Consequences of noncompliance
(2) [2:223] Corporate employer requirements
(a) [2:223e] Change to option deemed new option
1) [2:223f] Offer to modify option
2) [2:223g] Certain corporate transactions excepted
(3) [2:223.1] Employee stock purchase plans
d. [2:228] Retirement benefits—favorable tax treatment not limited to corporate entities
(1) [2:228.1] Advantages of "tax-qualified" plan
(a) [2:228.2] Plan must be for *employees*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) [2:228.2a] Keogh plans for self-employed individuals
2) [2:228.2b] Compare—S corporation shareholders
(2) 2023 maximum annual deductions
(a) [2:228.4] Inflation adjustment
(3) [2:228.5] Discriminatory plans prohibited
e. [2:229] Caution—§ 269A trap for "personal service corporations"
(1) [2:230] "Personal service corporation" defined
(a) [2:231] Application

[2:84] It is frequently observed that the form of business entity should not be selected *solely* for tax reasons. In many instances, the dollar difference in tax liability between a corporation and pass-through entity may not be significant, so that nontax considerations may predominate in choosing the type of entity. Nonetheless, tax consequences are always important. It is therefore imperative to review with the client the major tax differences between doing business as a corporation vs. a sole proprietorship, partnership or LLC.

1. [2:85] **Taxation of Business Income:** The fundamental difference between a corporation on the one hand, and a sole proprietorship, partnership or LLC on the other, is that the *corporation is a separate tax-paying entity* (unless it is an S corporation for tax purposes; *see ¶ 2:119*). In contrast, *non*corporate entities are treated for tax purposes as "conduits," with taxable income (or loss) "passing through" and taxable to the owner(s).

Cross-refer: The following is an overview of taxation of noncorporate pass-through entities. For a detailed discussion, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 8.

a. [2:85.1] **Overview of federal legislation:** Current federal tax law rates were established by the Tax Cuts and Jobs Act of 2017 (TCJA), P.L. 115-97, 131 Stat. 2054, as modified by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), P.L. 116-136, 134 Stat. 281 (effective in tax years beginning on January 1, 2021). The current federal tax rates for the most part remain unchanged despite two major pieces of legislation containing tax provisions: the CHIPS Act of 2022, P.L. 117-167, 136 Stats. 1366 (Creating Helpful Incentives to Produce Semiconductors), and the Inflation Reduction Act of 2022 (IRA), P.L. 117-169, 136 Stats. 1818.

(1) [2:85.2] **Corporate rates:** The Code imposes a flat corporate tax rate of *21%* at all income levels. [IRC § 11(a), (b); *see ¶ 2:102*]

(2) [2:85.3] **Individual (personal) rates:** The 21% corporate rate is lower than the ordinary income rates imposed on single individuals earning more than $47,150 and married couples earning more than $94,300 (joint return), and is significantly lower than the top 37% rate imposed on individuals earning more than $609,350 for single filers and $731,200 for joint filers. [IRC § 1; Rev.Proc. 2023-34, 2023-48 IRB 1287; *see ¶ 2:99*]

(3) [2:85.4] **Owners of pass-through entities:** Owners of pass-through entities are generally allowed to deduct 20% of certain "nonwage" income ("qualified business income") of pass-through entities. [IRC § 199A(a), (b)]

The intention is to tax the owners' "wage" income at the standard individual rates, but to encourage business ownership by granting a deduction to the owners equal to 20% of the business' profits. Additionally, the 20% deduction is intended to spur economic growth by favoring businesses that invest in machinery, equipment and other tangible assets. *See ¶ 2:88 ff.*

[2:85.5 - 2:85.6] ***Reserved.***

➪ [2:85.7] ***PRACTICE POINTER:*** Whether individual business owners will pay more or less in taxes if the business is in corporate or pass-through form depends on the income levels and tax situations of the individuals. However, it should be noted certain fringe benefits are available exclusively to corporations (*see ¶ 2:197 ff.*), which may tip the scales in favor of the corporate form. If the business' income can be predicted with some degree of certainty and is not likely to fluctuate from year to year, attorneys may want to consult with the owners' tax advisors before choosing the form of business entity.

[2:85.8 - 2:85.9] ***Reserved.***

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b. [2:85.10] **California tax law:** California's tax system generally conforms to the federal tax laws, although with lower rates. Significantly, however, there is no provision comparable to the 20% federal deduction for "qualified business income" (¶ 2:88 ff.) received from pass-through entities.

c. [2:86] **Pass-through entities (sole proprietorship, partnership, LLC):** The net profits (income less deductions) of a sole proprietorship, partnership or LLC are taxable each year to the sole proprietor, partners or LLC members.

(1) [2:86.1] **Disadvantages if earnings retained:** A business' net profits are taxable whether or not distributed. Where significant amounts are not distributed in a tax year, the owner(s) could be left with tax liabilities but insufficient funds with which to pay the liabilities. (Here, corporations enjoy a distinct advantage, because they can retain profits for future investment so long as they are not hit with an accumulated earnings tax, ¶ 2:113).

(2) [2:87] **Advantages if losses contemplated:** Losses from a pass-through business in which the owner (sole proprietor, partner of member) "materially participates" (¶ *2:87.5*) can be used to offset any other income of the owner. Thus, if the business is expected to operate at a loss for some period of time, this form of ownership may be advantageous at the outset.

(a) [2:87.1] **Limitation on "passive activity" losses:** There are some important limitations on the deductibility of losses from *trade or business activities* in which the taxpayer does not "materially participate" (¶ *2:87.5*). [IRC § 469]

These limitations apply not only to individuals and sole proprietors, but also to general and limited partners (¶ *2:93.2 ff.*), LLC members (¶ 2:97.18), S corporation shareholders (¶ *2:123*), certain closely-held corporations (¶ *2:118.3 ff.*) and personal service corporations (¶ *2:118.14 ff.*).

1) [2:87.2] **Three categories of income or loss:** Under these rules, there are three categories of income or loss:

- **Active income or loss**, i.e., income or loss from a trade or business in which the taxpayer "*materially participates*"—including income from personal services by individuals (e.g., salary and bonuses), and net operating business income of closely-held corporations (IRC § 469(e)(2), (3));

- **Passive activity income or loss**, i.e., income or loss from a trade or business in which the taxpayer does *not* "materially participate"; and

- **Portfolio income or loss**, i.e., dividends, interest, capital gain or loss from investments, royalties, net income from publicly traded partnerships, etc. [IRC § 469]

2) [2:87.3] **Deductibility of active and passive losses:** Active losses are *fully deductible* from all three types of income. But a *pass-through owner* may deduct "passive activity" losses *only* from "passive activity" income—i.e., not from active income or portfolio income. [IRC § 469]

a) [2:87.4] **Effect:** Thus, for a pass-through owner's business losses to be *fully* deductible against *all* other income (not just income from passive activities), the owner must "*materially participate*" in the business (¶ 2:87.5 ff.).

b) [2:87.4a] **Passive activity losses deductible in future years:** Any "passive activity" loss not deductible in the current year is carried forward to be deducted against "passive activity" income in future years, or upon *complete disposition* of the investment (¶ *2:87.11*). [IRC § 469(b),(g)]

3) [2:87.5] **Tests for "material participation":** A taxpayer "materially participates" in a business activity only if *personally involved* in its management or operation on a *regular, continuous and substantial basis throughout each tax year*. [IRC § 469(h)]

a) [2:87.6] **General "facts and circumstances" test:** "Material participation" will be found to exist if all relevant facts and circumstances demonstrate the requisite taxpayer involvement in the activity. Material participation will most likely be found where the activity is the taxpayer's *principal business*, or one in which the taxpayer works full-time (either in management or operations). [Treas.Reg. § 1.469-5T(a)(7),(b)(2) (temp.)]

A relevant factor may be how *regularly* the taxpayer is *personally present* at the business premises. However, subject to the limitations noted below (¶ 2:87.6a), a taxpayer may materially participate in an activity if the taxpayer does all that is required to conduct the activity, even if the actual amount of work involved is low compared to other activities. [See *Carter Trust ex rel. Fortson v. United States* (ND TX 2003) 256 F.Supp.2d 536, 541—trust's "material participation" measured by all persons who conduct its business (not just trustee)]

- [2:87.6a] **Limitations:** But a taxpayer cannot materially participate under the "facts and circumstances" test if the taxpayer participates in the activity *less than 100 hours* during the tax year.

Nor is the test satisfied where the taxpayer's participation consists *solely* of *management services* … unless (i) no one else is paid to perform management services; and (ii) no one else performs more management services than the taxpayer. [Treas.Reg. § 1.469-5T(b)(2) (temp.)]

b) [2:87.7] **Six "quantitative" tests under IRS Regs.:** Temporary IRS Regulations establish six "quantitative" tests for determining "material participation" in an activity. Material participation will be deemed to exist if any *one* of the following tests is satisfied:

- The individual participates in the activity for *more than 500 hours* during the tax year;

- The individual's participation during the tax year constitutes *substantially all* of the participation in the activity of all individuals (including nonowners) during the year;

- The individual participates in the activity for *more than 100 hours* during the tax year *and* that participation is not less than that of anyone else for the year;

- The activity is a "significant participation activity" (i.e., an activity in which the taxpayer does not "materially participate" under the IRS tests, but in which the taxpayer participates for more than 100 hours during the year) and the individual's *aggregate* participation in *all* significant participation activities during the year exceeds *500 hours*;

- The individual materially participated in the activity for *any five* of the immediately preceding 10 tax years (whether or not consecutive); *or*

- The activity is a "personal service activity" (i.e., performance of personal services in law, health, engineering, architecture, accounting, actuarial science, consulting, the performing arts, or any other business in which capital is not a material income-producing factor), and the individual materially participated in the activity for *any three previous years* (whether or not consecutive). [Treas.Reg. § 1.469-5T(a),(c),(d) (temp.); see *Mordkin v. Commr.*, TC Memo 1996-187]

c) [2:87.7a] **"Grouped" activities:** A taxpayer's participation in more than one activity may be "grouped" with the taxpayer's participation in another activity (or activities) where the activities form an "appropriate economic unit." This is determined by looking at all the facts and circumstances, with the greatest weight placed upon (i) similarities and differences in types of trades or businesses, (ii) the extent of common control, (iii) the extent of common ownership, (iv) geographic location, and (v) interdependence between or among the activities. [Treas.Reg. § 1.469-4(c)(1), (2); see *Gregg v. United States* (D OR 2000) 186 F.Supp.2d 1123, 1132-1133—LLC member who worked only 100 hours for LLC could group that activity with his full-time CEO position with corporation having similar business to LLC (thereby meeting 500-hour test)]

1/ [2:87.7b] **Limitations:** There are limitations on the activities that may be grouped, especially where one of the activities is a *rental* activity. [See Treas.Reg. § 1.469-4(d)]

d) [2:87.7c] **Capacity in which taxpayer participates immaterial:** Generally, any type of work is counted toward satisfying the "material participation" tests. The capacity in which the taxpayer performs the work or services is immaterial. [Treas.Reg. § 1.469-5T(f)(1) (temp.)]

But, of course, work performed only in the capacity of an *investor* (e.g., reviewing financial and other reports, or monitoring an activity in a nonmanagerial capacity) is not "participation." [Treas.Reg. § 1.469-5T(f)(2) (temp.)]

e) [2:87.7d] **Spouse's participation included:** A spouse's participation in an activity is treated as participation by the taxpayer, regardless of whether the spouse owns an interest in the activity or the taxpayer and spouse file a joint tax return. [Treas.Reg. § 1.469-5T(f)(3) (temp.)]

f) [2:87.7e] **Ways to document participation:** "Any reasonable means" may be used to document material participation. This includes appointment books, calendars or narrative summaries. Contemporaneous daily time reports or logs are not strictly required. [Treas.Reg. § 1.469-5T(f)(4) (temp.)]

➪ [2:87.7f] ***PRACTICE POINTER:*** Nevertheless, it is prudent to keep contemporaneous records of the time spent participating in the activity. [See *Harnett v. Commr.*, TC Memo 2011-191—taxpayer's self-serving

testimony regarding time spent on real estate investments based on after-the-fact attempt to recreate hours in response to tax audit inadequate to show material participation ("The regulations do not allow a postevent 'ballpark guesstimate'")]

4) [2:87.8] **Rental activities subject to more stringent standard:** A taxpayer's "material participation" in "rental activities" (¶ 2:87.8a) is *not* sufficient to remove the activity from the passive loss limitation rules. For an *individual*, losses from such activities can be deducted against active or portfolio income *only where:*

• The taxpayer materially participates in a real property *trade or business* (i.e., property development, construction, acquisition, conversion, rental, management, leasing or brokerage); *and*

• At least *750 hours*—amounting to *more than half* of the taxpayer's business services for the taxable year—are performed *personally* in that trade or business (i.e., a spouse's services are not counted). Personal services performed as an employee do not qualify unless the employee is a minimum 5% owner. [IRC § 469(c)(2), (7)(A)-(C) & (D)(ii); see *Gragg v. United States* (9th Cir. 2016) 831 F3d 1189, 1191-1192—taxpayer's status as real estate professional does not excuse compliance with material participation test; *Moss v. Commr*. (2010) 135 TC 365, 370—time that taxpayer was "on call" to perform services on rental properties did not count toward 750-hour requirement]

A *closely-held C corporation* (*see ¶ 2:118.4*) may offset losses from "rental activities" against other income if *more than 50% of its gross receipts* are derived from real property trades or businesses in which the corporation materially participates (*see ¶ 2:118.10 ff.*). [IRC § 469(c)(7)(D)(i)]

a) [2:87.8a] **"Rental activities" defined:** "Rental activities" for this purpose are those that generate income from the use of *tangible* property (as opposed to payments for service)—e.g., rentals of apartments, office equipment and automobiles (Treas.Reg. § 1.469-1T(e)(3)(i) (temp.)).

Complex IRS Regulations specify certain activities that are *not* "rental activities" and thus *not* treated as passive. These include activities involving:

• Only *minimum periods* of rental use (e.g., fewer than seven days);

• Performance of significant or "extraordinary" *personal services* to make the property available for customers' use (e.g., use of hospital rooms by patients); and

• Rentals that are only *incidental* to the conduct of a business. [See Treas.Reg. § 1.469-1T(e)(3)(ii) (temp.)]

b) [2:87.9] **Exception—$25,000 offset for losses from rental real estate:** In any event, an *individual* taxpayer may annually offset up to $25,000 of taxable income from any source (i.e., both passive and nonpassive) by deducting net losses (and credits) from a *real estate rental* activity if the taxpayer:

• Owns a *10%* or greater interest (by value) in such activity; *and*

• *Actively participates* in its management (¶ 2:87.10). [IRC § 469(i)]

But this $25,000 offset is phased out between $100,000 and $150,000 of adjusted gross income. [IRC § 469(i)(3)]

1/ [2:87.10] **"Active participation":** The "active participation" requirement is generally not as onerous as the "material participation" standard. It does not require regular, continuous and substantial involvement in the activity.

Rather, "active" participation will exist so long as the individual taxpayer participates in the real estate rental activity in a *significant* and *bona fide* way (e.g., making management decisions, or arranging for others to provide such services as maintenance or repairs). [IRC § 469(i)(6)]

5) [2:87.11] **Limitations cease upon disposition of interest in "passive activity":** The limitations on deductibility of "passive activity" losses cease when the taxpayer *completely disposes* of his or her (or its, *¶ 2:118.3*) interest in the passive activity in a fully taxable *arm's-length* transaction. Loss on the transaction, plus all previously undeducted passive activity losses carried forward from past years ("suspended losses"), may be fully deducted from *any* taxable income (i.e., from passive, active and portfolio income). [IRC § 469(g)]

a) [2:87.12] **Not applicable to tax-free exchange:** A transfer of the property to a corporation in an IRC § 351 tax-free exchange (*¶ 3:331 ff.*) would *not* constitute such a disposition.

[2:87.13 - 2:87.20] ***Reserved.***

(b) [2:87.21] **Limitation on excess business losses:** For tax years 2021 through 2028, a noncorporate taxpayer is not allowed to claim a deduction for any business losses above the "excess business loss" threshold. Losses above the "excess business loss" threshold (¶ 2:87.22) that are disallowed are treated as a net operating loss (NOL) for the current year for the purpose of determining any NOL carryover to a subsequent tax year. [IRC § 172(a), (b)]

The deductibility of business losses is determined after applying the "passive activity loss" rules (IRC § 469; *see* ¶ 2:87.1 ff.). [IRC § 461(*l*)(6)]

1) [2:87.22] **Excess business loss threshold:** For taxable years beginning on or after January 1, 2024, the excess business loss threshold is $305,000 for single taxpayers and $610,000 for married taxpayers filing jointly. [Rev.Proc. 2023-34, 2023-48 IRB 1287]

2) [2:87.23] **Application to partnerships and S corporations:** For partnerships, LLCs, and S corporations, the excess business loss rules apply at the partner, LLC member, or S corporation shareholder level. [IRC § 461(*l*)(4)]

3) [2:87.24] **Limitation on NOL carryovers:** For taxable years beginning after 2020, NOLs arising in tax years beginning after 2017 may offset no more than 80% of the noncorporate taxpayer's taxable income in the carryback or carryforward year. [IRC § 172(a)(2)]

4) [2:87.25] **NOLs after 2017:** A two-year carryback and 20-year carryforward generally apply to NOLs arising in tax years beginning before 2018. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) allowed noncorporate taxpayers to carry back NOLs incurred in 2018, 2019 and 2020 to each of the five taxable years preceding the taxable year the NOL was incurred. [CARES Act, P.L. 116-136, 134 Stat. 281, § 2303; see IRC § 172(b)(1)(D)(i)] A taxpayer may elect to waive the carryback. [IRC § 172(b)(3)]

Beginning after 2020, no carryback and an unlimited carryforward period generally apply to NOLs arising in tax years beginning after 2020. However, NOLs incurred in 2018, 2019, and 2020 and carried over to tax years after 2020 *will* be subject to the 80% limitation. [IRC § 172(a)(2), (b)(2)]

(3) [2:88] **20% deduction for "qualified business income" (QBI):** An individual taxpayer generally may deduct 20% of "qualified business income" (QBI, ¶ 2:88.1) earned from certain pass-through entities (¶ 2:88.3). The deduction is applied on a *per business*, *not a per taxpayer* basis. [IRC § 199A(a),(b)]

The deduction does not apply for taxable years beginning after December 31, 2025. [IRC § 199A(i)]

(a) [2:88.1] **QBI defined:** Generally, QBI is the net amount of domestic qualified items of income, gain, deduction and loss with respect to a taxpayer's qualified businesses (without regard for reasonable compensation in an S corporation or guaranteed payments for services in a partnership or LLC). [IRC § 199A(c)(1)]

1) [2:88.2] **Exclusions:** The following are excluded from the definition of QBI:

- *S corporation disbursements* treated as *reasonable compensation* of the taxpayer;
- *Guaranteed payments* to a *partner* (or *LLC member*) for *services rendered with respect to a trade or business*;
- Amounts allocated or distributed by a partnership (or LLC) for services to a partner (or member) who is acting *outside their capacity as a partner* (or *member*) to the extent provided in regulations; and
- Certain *investment-related* income, gain, deduction or loss. [IRC § 199A(c)(1), (3)(B), (4)]

(b) [2:88.3] **Applicable pass-through entities:** The 20% deduction applies to income from sole proprietorships, partnerships (including qualified publicly traded partnerships, ¶ 2:93.1), LLCs and S corporations. (It also applies to qualified real estate investment trust (REIT) dividends and qualified cooperative dividends.) [IRC § 199A(a), (b)(1), (e)(3)-(5), (f)(1)(A), (g)]

(c) [2:88.4] **Wage and capital limitation:** The amount of the 20% deduction is reduced by a wage and capital limitation based on the *greater* of:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• 50% of "W-2 wages" that the business paid to its employees and properly allocated to its QBI, or

• the sum of 25% of "W-2 wages" *plus* a capital allowance equal to 2.5% of the unadjusted basis (immediately after acquisition) of "qualified property"—i.e., tangible property subject to depreciation and available for use in the business at the end of the year. [IRC § 199A(b)(2)]

The limitation is phased in above a threshold amount of taxable income—i.e., $191,950 for single taxpayers and $383,900 for married taxpayers filing jointly. (These amounts are indexed for inflation.) [IRC § 199A(b)(3), (e)(2); Rev.Proc. 2023-34, 2023-48 IRB 1287]

1) [2:88.4a] **"W-2 wages" defined:** "W-2 wages" generally are the total wages paid by the business that are subject to wage withholding, plus any elective deferrals and any deferred compensation paid by the business with respect to employment of its employees during the calendar year ending during its taxable year and properly allocated to its QBI. [IRC § 199A(b)(4); see IRC § 6051(a)(3), (8)]

(d) [2:88.5] **Disallowance for certain service businesses "specified service trade or business":** Above a threshold amount of taxable income ($191,950 for single taxpayers and $383,900 for married taxpayers filing jointly, as indexed for inflation), a disallowance of the 20% deduction is phased in with respect to a "specified service trade or business." A "specified service trade or business" is any business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners." [IRC §§ 199A(d) & (e)(2), 1202(e)(3)(A); Rev.Proc. 2023-34, 2023-48 IRB 1287]

The 20% deduction does not apply to the trade or business of being an employee. [IRC § 199A(d)(1)(B)]

1) [2:88.5a] **Engineering and architecture excepted:** Businesses that provide engineering or architecture services are excluded from the definition of "specified service trade or business." [IRC § 199A(d)(2)(A)]

2) [2:88.5b] **"De minimus" exception for combined trade/service business:** Under *proposed* regulations, a business that both sells product and performs services will *not* be treated as a "specified service trade or business" if it has gross receipts of *$25 million or less* for the tax year and less than *10%* of the gross receipts are attributable to the performance of services. If the gross receipts are *more than $25 million*, the business will not be treated as a "specified service trade or business" if less than *5%* of the gross receipts are attributable to the performance of services. [Treas.Reg. § 1.199A-5(c)(1)]

(e) [2:88.6] **Effect of phase-ins:** The 20% deduction is applied to reduce *taxable* income rather than *adjusted gross* income. The limitations with respect to wages and capital (¶ 2:88.4) and specified service trades or businesses (¶ 2:88.5) are fully phased in once taxable income exceeds:

• The threshold amount ($191,950 for single returns, $383,900 for joint returns, as indexed for inflation), *plus*

• $50,000 for single returns and $100,000 for joint returns. [IRC § 199A(b)(3),(e)(2); Rev.Proc. 2023-34, 2023-48 IRB 1287]

So, for taxpayers with taxable income *below* the threshold amount of $191,950 for single returns and $383,900 for joint returns, the limitations do *not* apply. Conversely, the limitations *fully* apply to married taxpayers with taxable income over $483,900 and single taxpayers with taxable income over $241,950. [Rev.Proc. 2023-34, 2023-48 IRB 1287]

(f) Examples

1) [2:88.7] **Taxable income below threshold amount:** If an individual's taxable income is $80,000 (below the threshold amount of $192,950 for single returns and $383,900 for joint returns) and the individual's QBI is $60,000, the deduction is *$12,000* (20% of $60,000).

2) [2:88.8] **Taxable income above threshold amount and no specified service business:** Assume that the taxpayer (i) operates a business that is not a specified service business (¶ 2:88.5), (ii) files a joint return reporting taxable income of $400,000, with $175,000 of QBI (*see* ¶ 2:88.1) and $50,000 in "W-2 wages" (*see ¶ 2:88.4*), and (iii) places in service $200,000 of equipment (qualified property, ¶ 2:88.4) for the business.

A simplified example of the limitation is as follows:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- **Step 1:** 20% of QBI is *$35,000* (tentative QBI deduction).

- **Step 2:** The wage and capital limitation (¶ 2:88.4) is the *greater* of:

— 50% of W-2 wages ($25,000), or

— 25% of W-2 wages ($12,500), plus 2.5% of the unadjusted basis of the equipment ($5,000), which equals $17,500.

The greater of the two is *$25,000*.

- **Step 3:** Since *$25,000* from Step 2 is less than *$35,000* from Step 1, the wage and capital limit applies and the deduction is reduced according to the phase-in (¶ 2:88.4 ff.). The applicable percentage reduction is $400,000 minus $383,900 (the threshold amount) divided by $100,000 (the phase-in range)—i.e., *16.1%*.

- **Step 4:** The tentative QBI deduction of *$35,000* is reduced by the difference between *$35,000* (Step 1) and *$25,000* (Step 2), or $10,000, multiplied by 16.1% (Step 3), which is $1,610. The actual deduction will be $35,000 minus $1,610, which equals *$33,390*.

(4) [2:89] **Special considerations re partnerships:** As stated above (¶ 2:85), a partnership is *not* a tax-paying entity. Whether general or limited, a partnership is merely a *conduit* for tax purposes: It files an informational return (Form 1065), showing the income and expenses of the partnership business and each partner's *distributive share* of those items (usually as determined from the partnership agreement). [IRC §§ 702-704; see *United States v. Woods* (2013) 571 US 31, 38, 134 S.Ct. 557, 562; *Davis v. United States* (9th Cir. 2016) 811 F3d 335, 340; *Candyce Martin 1999 Irrevocable Trust v. United States* (9th Cir. 2014) 739 F3d 1204, 1210]

(“Small” partnerships—i.e., those with 10 or fewer partners—that satisfy certain specified conditions, are not subject to the penalty imposed by IRC § 6698 for failure to file federal “informational” tax returns. [IRC §§ 6231(a)(1)(B), 6698(a); Rev.Proc. 84-35, 1984-1 CB 509] *But caution:* There is no similar filing exemption under California law.)

(a) [2:90] **Profits and losses “passed through” to partners:** Since the partnership is not a tax-paying entity, all partners are required to pick up on their personal income tax returns their distributive shares of any profits realized by the business, whether or not actually distributed to the partners. [IRC § 702] This, of course, makes it difficult to retain high profits in the business, since the partners will want distributions to cover their taxes.

Similarly, partnership *losses* are “passed through” to the partners, and may be utilized to *reduce other taxable income*, subject to *basis* limitations, “*at risk*” loss limitations and “*passive activity*” loss limitations (*¶ 2:93.2 ff.*).

(b) [2:91] **Advantage for tax-sheltering:** Partners are entitled to write off their share of partnership losses even if such losses *exceed* the amount they have invested (their basis) in the partnership … to the extent they are “at risk” on the partnership debts.

1) [2:92] **Special advantage for real estate limited partnerships:** Normally, of course, *limited* partners are *not* “at risk” on partnership debts, and therefore are not allowed to write off losses exceeding the amount of their investments. But there is one *exception*: In *real estate limited partnerships*, all partners (general and limited) are entitled to include their share of “*nonrecourse*” mortgage debt (i.e., debt on which no partner is personally liable) owed to qualified *third-party* lenders (e.g., institutional or government guaranteed lenders) in determining the amount of their investment —even though they are not “at risk” thereon. This exception does not apply to most seller or promoter-furnished financing. [IRC § 465(b); see Treas.Reg. § 1.465-27]

This is an important advantage for “tax-sheltering.” The partners can in effect “gross-up” the tax basis on their investments by including their proportionate share of third-party mortgage debt. This entitles them to larger depreciation deductions and thus to larger write-offs against taxable income from other *passive activities* (*see ¶ 2:93.4*).

2) [2:93] **Compare—corporations:** Corporations, on the other hand, provide no way for “grossing up” the investor's basis. Even with an S corporation (¶ 2:119 ff.), losses passed through to the shareholders are *limited* to the amount invested for their shares or as loans to the corporation; *see ¶ 2:124*.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [2:93.1] **Compare—"publicly traded" partnerships:** Special rules apply to "publicly traded" partnerships—i.e., partnerships whose interests are traded on an established securities market or are readily tradeable on a secondary market: A publicly traded partnership will be treated *like a corporation* for tax purposes, *unless at least 90% of its gross income is "passive-type" income* (e.g., interest, dividends, real property rents and gains, etc.). In effect, the partnership is treated as if it incorporated "tax-free" under IRC § 351 (*see ¶ 2:160 ff.*). [IRC § 7704; see Treas.Reg. § 1.7704-1]

(d) "Passive activity" loss limitations

1) [2:93.2] **General partners:** As stated above (*¶ 2:87.1 ff.*), general partners can fully deduct their share of net partnership losses only if they "materially participate" in the partnership business. Absent such participation, a general partner may deduct partnership losses solely against "*passive activity*" income (*¶ 2:87.2*). [IRC § 469]

Whether a general partner "materially participates" in the partnership business will be determined on a case-by-case basis, with reference to all relevant facts and circumstances. However, the partner must be *personally involved* in the partnership business on a *regular, substantial and continuous basis* (*see ¶ 2:87.5 ff.*).

• [2:93.3] **Example:** X and Y form a general partnership to operate a travel agency. X provides the start-up capital, while Y actually runs the business on a day-to-day basis. Although X approves major capital outlays, she does not participate in the business on a regular basis. Y may deduct his share of start-up losses from *all* of his income, whatever the source (e.g., salary, bonuses, interest income). But X may deduct her share of losses only from *passive activity* income (this includes her income from the partnership business; *¶ 2:87.3*).

2) [2:93.4] **Limited partners presumed passive:** Subject to important exceptions, limited partners are *conclusively presumed NOT* to "materially participate" in the partnership business—i.e., they are presumed to be *passive*. Thus, limited partners generally may deduct their share of net partnership losses only from "passive activity" income. [IRC § 469(h)(2)]

This presumption applies even if the taxpayer holds the limited partnership interest *indirectly* through a tiered entity arrangement (e.g., where the taxpayer is a general partner or S corporation shareholder and the limited partnership interest is owned by such general partnership or S corporation).

a) [2:93.5] **Exceptions—material participation by limited partners:** A limited partner materially participates in a partnership activity—and thereby avoids passive treatment—if:

• The limited partner participates in the activity for *more than 500 hours* during the partnership tax year;

• The limited partner materially participated in the activity for any five of the immediately preceding 10 tax years (whether or not consecutive);

• The activity is a personal service activity (*¶ 2:87.7*) and the limited partner materially participated in it for any three previous tax years (whether or not consecutive); or

• The limited partner is also a *general* partner at all times during the partnership's tax year ending with (or within) the partner's tax year (or the portion of the partnership's taxable year during which the partner holds the limited partnership interest). [Treas.Reg. § 1.469-5T(e)(2), (3)(ii) (temp.)]

[2:93.5a] ***Caution—active limited partners may lose limited liability:*** However, a limited partner who "materially participates" in a partnership activity risks being considered a *general* partner under state law, and thus losing the limited liability shield (*see ¶ 2:27 ff.*). The tax benefits must be carefully weighed against the potential liability exposure.

[2:93.5b - 2:93.5d] ***Reserved.***

b) [2:93.5e] **Not applicable to LLC members:** LLC members are not deemed limited partners for purposes of IRC § 469(h)(2) or Treas.Reg. § 1.469-5T (temp.). Although LLC members, like limited partners, enjoy limited liability, they differ from limited partners in that they are *not* precluded from actively participating in the company's business. Thus, LLC members are not conclusively presumed to be passive and hence are not restricted to deducting LLC losses from "passive activity" income. Rather, LLC members are more akin to *general* partners and hence,

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

with respect to "passive activity" loss limitations, should be dealt with under rules applicable to general partners. [*Garnett v. Commr*. (2009) 132 TC 368; *Thompson v. United States* (2009) 87 Fed.Cl. 728, 738-739, acq. 2010-14 IRB 515; *Newell v. Commr*., TC Memo 2010-23]

3) [2:93.6] **Compare—"publicly traded" partnerships:** Partnerships whose interests are traded on an established securities market or are readily tradeable in a secondary market are treated differently under the "passive activity" rules. *Net income* from such partnerships is treated as "portfolio income," not as "passive income."

Further, the partners may not deduct *net losses* against any of their other income (except for the $25,000 offset for real estate rental losses; ¶ *2:87.9*). Instead, losses are suspended and carried forward to be used only against future net partnership income, or upon complete disposition of the partnership interest (*see* ¶ *2:87.11*). [IRC § 469(k)]

a) [2:93.7] **Compare—"non-passive" publicly traded partnerships:** If less than 90% of a publicly traded partnership's gross income is from "passive-type" sources, the partnership will be treated as a corporation for tax purposes. Thus, its income or loss will be taxed to the entity at corporate rates. [IRC § 7704; *see* ¶ *2:93.1*]

[2:94] ***Reserved.***

(e) [2:95] **Fiscal year:** A partnership may not adopt a different fiscal year than its partners to postpone the year in which the partnership profits will be taxable to them. Unless it establishes a business purpose for a different tax year, the Code requires that the partnership report on the same fiscal basis as the partners owning a majority of the partnership profits and capital. If the majority owners do not have the same tax year, the partnership must adopt the same tax year as its principal partners (i.e., those owning 5% or more of the partnership capital or profits). If the principal partners do not all have the same tax year, the partnership must adopt the calendar year as its tax year. [IRC § 706(b); Treas.Reg. § 1.706-1(b)]

1) [2:96] **"Business purpose" deferral rule:** However, a partnership may adopt a different fiscal year from its partners if a valid *business purpose* for the change is shown. [IRC § 706; Treas.Reg. § 1.706-1(b)(2)(ii)] Rev.Proc. 2006-46 provides for automatic procedures for a partnership, S corporation or electing S corporation and a personal service corporation to change its tax year. An entity that cannot file under the automatic procedures must file under the nonautomatic procedures and establish a business purpose to obtain the approval of the IRS for its requested change of tax year. [Rev.Proc. 2002-39]

2) [2:96.1] **Three-month deferral election:** Further, a partnership (as well as an S corporation or personal service corporation) can elect a different taxable year *without* the Commissioner's consent so long as this does not result in a deferral of income to the partners of more than three months … meaning that the partnership usually must adopt a fiscal year ending in September, October or November. [IRC § 444; Treas.Reg. § 1.706-1(b)(2)(ii)] (But a partnership so electing must still make a prescribed estimated tax payment each April 15, or risk cancellation of its deferral election; IRC § 444(c).)

(f) [2:97] **Tax audits at partnership level:** Unless a partnership with fewer than 100 partners (who are all individuals) elects to be audited under the rules applicable to *individual* taxpayers, the partnership is treated as a *separate entity* for tax audit purposes. Each partnership is required to designate a "partnership representative," who need not be a partner (but must have a "substantial presence in the United States"). Audits are conducted at the partnership level, and the partnership representative has authority to bind the partnership. The tax treatment of any item is likewise determined at the partnership level, and any taxes, interest and penalties are assessed directly on, and collected from, the partnership and not from its individual partners. [IRC §§ 6221(a),(b), 6223, 6226(c)]

(g) [2:97.1] **Minimum franchise tax on limited partnerships:** All California *limited* partnerships (including LLPs; ¶ 2:321 ff.) must pay the same annual $800 minimum franchise tax that is imposed on corporations (¶ 2:102.2 ff.) and LLCs (¶ 2:97.22 ff.). [Rev. & Tax.C. §§ 17935, 17948]

1) [2:97.2] **First-year exemption:** Limited partnerships and LLPs that register on or after January 1, 2021, and before January 1, 2024, are exempt from the annual minimum franchise tax in their first taxable year. [Rev. & Tax.C. §§ 17935(f)(1), 17948(e)(1)]

2) [2:97.3] **Compare—general partnerships:** The minimum annual franchise tax is not imposed on general partnerships. [See Rev. & Tax.C. §§ 17935(a), (d), 17948(a), (b)]

[2:97.4] ***Reserved.***

(5) [2:97.5] **Special considerations re limited liability companies:** Here again, an LLC is treated as a *conduit* (i.e., a partnership) for federal tax purposes: Profits and losses are passed through to the LLC members and, in most other respects (e.g., informational returns, basis allocation), the members are subject to the same federal tax rules and treatment as partners. [See generally, *City of Los Angeles v. Furman Selz Capital Mgmt., L.L.C.* (2004) 121 CA4th 505, 513-514, 17 CR3d 139, 142-144]

For California franchise tax purposes, the LLC pays the annual minimum franchise tax and an additional franchise "fee" on income of $250,000 or more. *See ¶ 2:97.22 ff.*

[2:97.6 - 2:97.17] ***Reserved.***

(a) [2:97.18] **Applicability of partnership taxation provisions to LLCs:** An LLC and its members will experience the benefits (and drawbacks) commonly experienced by partnerships and partners. Significantly:

• Profits and losses are passed through to members (*¶ 2:90 ff.*);

• Since members are taxed upon their distributive shares of profits, they cannot avoid income tax by retaining profits in the business (¶ 2:86.1);

• An LLC must have the same tax year as its members unless it establishes a business purpose for a different tax year (*¶ 2:95 ff.*).

1) [2:97.19] **Exception—greater opportunity for leveraged basis than in limited partnership:** The primary difference in the tax treatment of LLCs and *limited* partnerships relates to the ability to leverage the basis of the entity owners. This could be significant where the business is expected to generate losses.

a) [2:97.20] **Effect of debt on member's basis:** A member's basis equals the member's contribution adjusted for the member's share of income (or losses) and distributions. Basis is also increased by the share of LLC debt allocated to the members in accordance with their membership interests … *unless* a particular member bears the *economic risk of loss* with respect to the obligation (i.e., where a member has personally guaranteed an LLC liability), in which case the portion of the debt for which the member is liable must be included in that member's basis. [See IRC §§ 705, 722, 752; Treas.Reg. § 1.752-3]

b) [2:97.21] **Compare—effect of debt on limited partner's basis:** Since *general* partners have personal liability for the debts of a limited partnership, *no portion* of the debts can be allocated to the *limited* partners. (An exception exists for real estate limited partnerships; *see ¶ 2:92*.) Hence, limited partnership debt *cannot* be used to increase a limited partner's basis. [See Treas.Reg. § 1.752-2(a),(b)]

(b) California tax treatment of LLC

1) [2:97.22] **Minimum franchise tax on LLCs:** California LLCs must pay the same annual $800 minimum franchise tax that is imposed on corporations (¶ *2:102.2 ff.*) and limited partnerships (¶ 2:97.1 ff.). [Rev. & Tax.C. § 17941]

a) [2:97.22a] **First-year exemption:** LLCs that register on or after January 1, 2021, and before January 1, 2024, are exempt from the minimum franchise tax in their *first* taxable year. [Rev. & Tax.C. § 17941(g)(1)]

b) [2:97.22b] **Exemption for small business LLCs owned by deployed armed forces member:** For taxable years beginning on or after January 1, 2020, if an LLC has total California income of $250,000 or less and is *solely* owned by a member of the U.S. armed forces, the $800 minimum franchise tax is not imposed for any taxable year that (i) the owner is *deployed* and (ii) the LLC either operates at a *loss* (i.e., expenses exceed receipts) or *ceases operation*. "Deployed" means being called to active duty or active service during a period when a Presidential Executive Order specifies that the United States is engaged in combat or homeland defense, but "deployed" does *not* include (i) temporary duty for the sole purpose of training or processing, or (ii) a permanent change of station. [Rev. & Tax.C. § 17941(f) *see* ¶ 2:102.4]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2) [2:97.23] **Additional "fee":** An LLC having *total income of $250,000 or more from all sources "derived from or attributable to this state"* must pay the following additional franchise "fee" based upon its income level (Rev. & Tax.C. § 17942 (emphasis added)):

Total Income	Fee
$250,000 to 499,999	$900
$500,000 to 999,999	$2,500
$1 million to 4,999,999	$6,000
$5 million or more	$11,790

(6) [2:98] **Taxation of individuals:** The income from pass-through entities is taxed directly to the owners (sole proprietors, partners, LLC members), and hence is subject to the rate structures and other rules governing individual taxation.

(a) [2:99] **Ordinary income rate structure:** The tax rates applicable to individuals are as follows (IRC § 1(a),(c),(f),(i); Rev.Proc. 2023-34, 2023-48 IRB 1287):

Taxable Income	Rate
Single Return	
0-$11,600	10%
$11,601-$47,150	12%
$47,151-$100,525	22%
$100,526-$191,950	24%
$191,951-$243,725	32%
$243,726-$609,350	35%
Over $609,350	37%
Taxable Income	**Rate**
Joint Return	
0-$23,200	10%
$23,201-$94,300	12%
$94,301-$201,050	22%
$201-051-$383,900	24%
$383,901-$487,450	32%
$487,451-$731,200	35%
Over $731,200	37%

Caution: The above income levels are in effect for *2024*. They are adjusted annually as of December 15 to account for inflation. [IRC § 1(a),(c),(f)(3)]

1) [2:100] **3.8% surtax on dividends and other "investment income":** In addition to the above rates, a tax of 3.8% (to support Medicare) is imposed on the "net investment income" of single return individuals whose total income exceeds *$200,000* and joint return couples whose total income exceeds *$250,000*. "Net investment income" includes income from "passive-activity" interests, royalties, rents and—significantly—*dividends*. [IRC § 1411(a)(1),(b),(c)]

(b) [2:100.1] **Capital gain rates—ordinarily, 20% maximum:** Generally, net gain from the sale (or other taxable disposition) of a capital asset held *more than 12 months* is taxed at *0%*, *15%* or *20%*, depending on the individual's income level. [IRC § 1(h)(1)(C)]

There are some exceptions (e.g., a 28% maximum rate applies to long-term capital gain from "collectibles" and from certain sales of small business stock ("§ 1202 gain"); ¶ 2:100.2 ff.).

The following table shows the capital gain rates combined with the 3.8% surtax on dividends and other "investment income" (*¶ 2:100*). [Rev.Proc. 2023-34, 2023-48 IRB 1287]

Taxable Income	Capital Gain Rate	§ 1411 Surtax	Combined Tax Rate
Single Return			
$0-$47,025	0%	0%	0%
$47,026-$200,000	15%	0%	15%
$200,001-$518,900	15%	3.8%	18.8%
Over $518,900	20%	3.8%	23.8%
Joint Return			

$0-$94,050	0%	0%	0%
$94,051-$250,000	15%	0%	15%
$250,001-$583,750	15%	3.8%	18.8%
Over $583,750	20%	3.8%	23.8%

(c) [2:100.2] **Exclusion of gain from "small business stock":** As an incentive to long-term investment in small businesses, noncorporate investors may exclude from their taxable income 100% of the gain from *qualified small business stock*. The stock must be held for *more than five* years and must have been acquired *after September 27, 2010*. (Note: There is still in effect a *75%* exclusion for stock acquired between February 18, 2009 and September 27, 2010, and a *50%* exclusion for stock acquired between August 11, 1993 and February 17, 2009.) [IRC § 1202]

Additionally, *any* excluded gain from qualified small business stock is not subject to the 3.8% "investment income" surtax (¶ *2:100*); and the *100% excluded gain* is not subject to the alternative minimum tax (¶ 2:100.11 ff.). [IRC §§ 1202(a)(4)(C), 1411(c)(1)(A)(iii)]

1) [2:100.3] **Qualifying criteria for "small business stock":** To qualify for this lower rate, the taxpayer must have acquired the stock upon its *original issuance* for cash, property or services (other than as an underwriter for the stock). The stock is limited to stock in a *C corporation* which, immediately following stock issuance, has a *maximum* of $50 million in aggregate gross assets (counting noncash property at its adjusted basis).

Additionally, at the date of issuance and substantially throughout the period the taxpayer held the stock, the corporation:

- must *not* be a regulated investment company, real estate investment trust, real estate mortgage investment trust, or other specified "tax-favored" entity;

- must *not* own investment or rental real property having a value exceeding 10% of total assets, or portfolio stock or securities having a value exceeding 10% of net assets (total assets minus liabilities); *and*

- must use at least 80% of its total assets (by value) in the active conduct of a trade or business ("active business requirement"), which may include startup research and development, but which specifically *excludes* professional services (such as legal, accounting, medical, performing arts, consulting, athletics, etc.) and banking, insurance, financing, leasing, farming, and hotel and restaurant businesses. [IRC § 1202(c),(e); see *Owen v. Commr.*, TC Memo 2012-21—use of only 8% of assets to acquire inventory (leaving remaining 92% as cash-on-hand "working capital" for more than 2 years) did not meet active business requirement]

2) [2:100.4] **Limitations on exclusion of gain:** The amount of gain eligible for the exclusion is limited to the *greater* of (i) $10 million or (ii) 10 times the taxpayer's basis in the stock. In addition, the exclusion does *not* apply if the corporation has repurchased, directly or indirectly, (i) *any* stock from the taxpayer or a "related person" within a four-year period beginning two years before issuance or (ii) more than 5% (by value) of its outstanding stock within a two-year period beginning one year before issuance. [IRC § 1202(b),(c)(3)]

3) [2:100.5] **Certain "tax-free" stock transfers permitted:** As stated above (¶ 2:100.3), the taxpayer must have acquired the stock upon its original issuance. Thus, shares purchased from an original shareholder do *not* qualify for the exclusion. However, a transferee who acquires the stock by *gift* or *inheritance* is treated as having acquired the stock in the same manner as the transferor, and the transferor's holding period is tacked on to the transferee's holding period. [IRC § 1202(h)(1) & (2)]

Similarly, stock acquired in exchange for small business stock in a tax-exempt § 368 reorganization is treated as small business stock. But the exclusion is limited to the amount of gain realized at the time of the exchange unless the issuing corporation is a qualified small business. [IRC § 1202(h)(4)]

4) [2:100.6] **Rollover of potential capital gain on sale of stock:** A noncorporate taxpayer may elect to "roll over" (defer) recognition of any gain on the sale of small business stock held for more than six months, but only to the extent the proceeds are reinvested within 60 days in other small business stock that meets the "active business requirement" (¶ 2:100.3) for at least six months following the purchase. The holding period of the sold stock will be tacked onto the replacement stock. [See IRC § 1045; Rev.Proc. 98-48, 1998-2 CB 367; see also *Owen v. Commr.*, TC

Memo 2012-21; and IRS Priv.Ltr.Rul. 201603010, 201603014—issuance that qualified for IRC § 1202 treatment not affected by corporation's subsequent conversion into LLC taxed as corporation]

[2:100.7 - 2:100.10] ***Reserved.***

(d) [2:100.11] **Alternative minimum tax (AMT):** An alternative minimum tax (AMT) is imposed to ensure that *all* individual taxpayers pay at least some tax. The AMT is triggered when the AMT rates result in tax greater than the regularly-computed tax liability. [IRC § 55(d)]

1) [2:100.12] **AMT income amounts (exemptions):** For 2024, the first $85,700 of an individual's AMT income ($133,300 for joint filers) is exempt from the AMT. (These exemption amounts are increased annually to account for inflation.) The exemption begins to phase out when an individual's income reaches $609,350 ($1,218,700 for joint returns), and completely phases out when an individual’s income reaches $952,150 ($1,751,900 for joint returns). [IRC § 55(d)(1)(A), (B), (3), (4); see Rev.Proc. 2023-34, 2023-48 IRB 1287]

A 26% AMT is assessed on AMT income over the exemption amount. The AMT increases to 28% when taxable AMT income reaches $110,350 for married individuals filing separate returns and $220,700 for all other taxpayers. [IRC § 55(b)(1)(A), (C); see Rev.Proc. 2023-34, 2023-48 IRB 1287]

2) [2:100.13] **Items included in AMT:** Various tax “preferences,” such as accelerated depreciation and net “passive activity losses,” are added in calculating AMT. [See IRC § 56(b); also see *Weiser v. United States* (9th Cir. 1992) 959 F2d 146, 147—whether preference item produced tax benefit is immaterial in calculating AMT]

d. [2:101] **Corporation:** In contrast to pass-through entities, a corporation is a *separate tax-paying entity*. It files its own tax return (Form 1120) and is taxed separately and apart from its shareholders.

(1) Corporate tax rates

(a) [2:102] **21% flat federal rate:** The Code imposes a flat 21% tax rate on all corporate income, including capital gains. The 21% rate also applies to certain personal service corporations. [IRC § 11; *see also* ¶ 2:85.1 ff.]

1) [2:102.1] **Corporate alternative minimum tax (AMT):** Except for certain large corporations, corporations are not subject to an AMT comparable to the AMT imposed on individuals (*see ¶ 2:100.11 ff.*). [See TCJA, P.L. 115-97, 131 Stat. 2054, § 12001]

For tax years beginning after 2022, the IRA imposes a 15% corporate alternative minimum tax on the adjusted financial statement income of certain large corporations that have a three-year average annual income in excess of $1 billion. [See IRC § 55]

(b) [2:102.2] **State franchise tax:** California imposes an 8.84% franchise (income) tax on corporate income derived from sources within the state. After its first taxable year, every corporation incorporated or doing business in California must pay an *annual $800 minimum* franchise tax (except for certain corporations owned by a deployed armed forces member; *see ¶ 2:102.4*). [Rev. & Tax.C. §§ 23151, 23153(d)]

1) [2:102.3] **First year exemption from minimum tax:** A corporation is *exempt* from the $800 minimum tax for its *first taxable year*. Thereafter, the corporation pays the same annual $800 minimum tax imposed on all other corporations (and on all limited partnerships and LLCs; *see* ¶ 2:97.1 ff., 2:97.22 ff.). [Rev. & Tax.C. §§ 23151(a), 23153(d), (f)]

2) [2:102.4] **Exemption for certain corporations owned by deployed armed forces member:** For taxable years beginning on or after January 1, 2020, if a corporation has total California income of *$250,000 or less* and is *solely owned* by a member of the U.S. armed forces, the $800 minimum franchise tax is not imposed for any taxable year that (i) the owner is *deployed* and (ii) the corporation either operates at a *loss* (i.e., has negative net income, per Corps.C. § 24341) or *ceases operation*. “Deployed” means being called to active duty or active service during a period when a Presidential Executive Order specifies that the United States is engaged in combat or homeland defense, but “deployed” does *not* include (i) temporary duty for the sole purpose of training or processing, or (ii) a permanent change of station. [Rev. & Tax.C. § 23153(i)]

(c) [2:102.5] **Compare—individual vs. corporate taxes:** Whether a corporation will pay less tax than a pass-through entity depends on numerous factors, including the prediction of income on a year-by-year basis, that are extremely

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

difficult to calculate. Moreover, tax law changes (which are inevitable) often are retroactive, thus making long-range tax planning virtually impossible even in those rare situations where taxable income can accurately be forecast.

Rather than focus on differences between corporate and individual rates, attorneys should determine whether corporations can effectively eliminate the corporate tax by electing Subchapter S status or paying out corporate profits to shareholders in the form of salaries, bonuses, interest, rents, etc. (¶ 2:105 ff.).

(2) [2:103] **Double taxation where dividends paid:** A drawback to the corporate form is that if corporate profits are distributed in the form of *dividends* to the shareholders, they are effectively taxed twice: First, the corporation will have paid a tax on those profits as earned; and then, the shareholders have to pay taxes individually for the dividends received. (The corporation gets *no deduction for dividends paid* to its noncorporate shareholders.) The profits so distributed are thus subjected to double taxation.

Although this drawback remains, it is less of a concern now that dividends are taxed *at the same rates as capital gains* (plus a *surtax* applicable to higher income taxpayers). This, combined with the flat corporate tax rate of 21% (¶ 2:102), means that the overall taxes paid by corporations versus pass-through entities (including S corporations) may not be materially different, *see ¶ 2:100.1*.

(a) [2:104] **Risk of penalty tax if dividends withheld:** Nor can a corporation simply withhold dividends to avoid the double tax. Even if the shareholders consent to this, there is a risk of penalty taxes on unreasonable accumulations of earnings (*see ¶ 2:113*).

(3) [2:105] **Compare—tax-deductible payments to shareholders:** Whereas dividends to shareholders are not deductible by the corporation, various other payments to the shareholders may be deductible business expenses: e.g., reasonable salaries for services rendered in the corporation's business, reasonable rent for property leased to the corporation in connection with its business, interest on bona fide loans by shareholders to the corporation, etc.

Thus, tax planning for a smaller corporation usually focuses on finding legitimate grounds for making payments to the shareholders as salaries, rent, etc. that will be deductible by the corporation—as opposed to distributing dividends which are *not* deductible.

(a) [2:106] **Limitation—"reasonable" business expenses:** Payments to shareholders as salaries, rents, reimbursements, etc. are deductible only to the extent they constitute "reasonable" expenses made in carrying on the corporation's trade or business. [IRC § 162]

Expenses lacking a business purpose (e.g., shareholders' personal expenses or salaries paid for nonbusiness pursuits), as well as payments exceeding a "reasonable" amount, are treated as "*constructive dividends*" to the shareholders—i.e., nonbusiness or excessive expenditures are *not* deductible by the corporation and the profits represented thereby are taxed twice. [See *DKD Enterprises v. Commr.* (8th Cir. 2012) 685 F3d 730, 734-736—corporation engaged in information technology consulting could not deduct salary paid to sole shareholder and other expenses relating to shareholder's cat-breeding pursuits (expenses treated as "constructive dividends"); *Eberl's Claim Service, Inc. v. Commr.* (10th Cir. 2001) 249 F3d 994, 998-1002; *Suder v. Commr.,* TC Memo 2014-201—portion of IRC § 174 research credit attributable to unreasonable compensation disallowed]

1) [2:106.1] **Factors determinative of "reasonable" compensation:** Factors considered by the courts in determining whether the amount of compensation is "reasonable" include:

- The employee's qualifications;
- The nature, extent and scope of the employee's work;
- The size and complexity of the business;
- The employer's financial condition;
- General economic conditions;
- Prevailing compensation rates for comparable positions in comparable companies;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The employer's salary policy for all employees (i.e., whether the compensation was paid under a formal, structured and consistently applied program);

• A comparison of salaries with gross income, net income, distributions to shareholders and retained earnings (e.g., whether a conflict of interest existed that could permit the company to disguise dividend payments as deductible compensation);

• Inadequacy of compensation paid in prior years; and

• Whether the employee guarantied the taxpayer's debt. [See *LabelGraphics, Inc. v. Commr*. (9th Cir. 2000) 221 F3d 1091, 1095-1100; *H.W. Johnson, Inc. v. Commr.*, TC Memo 2016-95; *Transupport, Inc. v. Commr*., TC Memo 2016-216; *Clary Hood, Inc. v. Commr.,* TC Memo 2022-15 (examining usual factors but denying deduction for full amount of compensation where taxpayer company failed to establish CEO shareholder's compensation was both reasonable and paid solely as compensation for services)]

a) [2:106.2] **"Independent investor's expected return":** Another factor that may determine "reasonable" compensation is whether an inactive, independent investor would be willing to pay such compensation to an employee in view of the return received on the investment. Although some courts (notably the Seventh Circuit) rely primarily on this factor, the Ninth Circuit does not regard it as decisive or controlling. [See *Metro Leasing & Develop. Corp. v. Commr*. (9th Cir. 2004) 376 F3d 1015, 1019; also see *Haffner's Service Stations, Inc. v. Commr.* (1st Cir. 2003) 326 F3d 1, 3-4; *Brinks Gilson & Lione P.C. v. Commr.*, TC Memo 2016-20; compare *Exacto Spring Corp. v. Commr*. (7th Cir. 1999) 196 F3d 833, 838-839—shareholder's salary reasonable where investors received 20% return vs. 13% reasonably expected return]

➪ [2:107] ***PRACTICE POINTERS:*** Year-end bonuses or retroactive salary raises are particularly suspect.

The "excessive compensation" problem can be lessened if the corporation distributes at least *some* of its profits as dividends, or retains them for reasonable future needs—as opposed to paying out *all* of its income to shareholder-employees as compensation and other employee benefits.

2) [2:107.1] **Caution—compensation allocated on basis of stock ownership (disguised dividend treatment):** Even where the amount of the compensation is reasonable, it must be wholly for services—i.e., it must have a purely *compensatory purpose*. Though labeled "compensation," corporate profits distributed among stockholder-employees in exact proportion to their stock ownership may be viewed as disguised dividends. [*O.S.C. & Assocs., Inc. v. Commr.* (9th Cir. 1999) 187 F3d 1116, 1119-1121; see Treas.Reg. § 1.162-7(b)(1)]

It is important to carefully document anything dealing with a payment to a related party where the IRS may gain a tax advantage by recharacterizing the payment. [See *Aspro, Inc. v. Commr.* (8th Cir. 2022) 32 F4th 673, 678-679—management fees paid to shareholders recharacterized as disguised distributions taxable as dividends where, among other things, corporation failed to (i) quantify value of services, (ii) show similar companies would pay same amount for similar services, or (iii) produce written agreement/documentation of service relationship]

[2:107.2 - 2:107.4] ***Reserved.***

3) [2:107.5] **Effect of repayment agreements:** One way to protect the corporation against disallowance of questionable deductions is for the employee-shareholders to enter into written agreements to *repay* to the corporation any compensation or expense payment determined to be "unreasonable" by the IRS. Repayments by the employees to the corporation under such an agreement would be *deductible by the employees* in the year repaid (see Rev.Rul. 69-115, 1969-1 CB 50; *Oswald v. Commr.* (1968) 49 TC 645).

But caution: The very existence of such agreement may be a "red flag" to the IRS if it discovers the agreement.

(b) [2:108] **Interest on debt owed to shareholders:** It is often advantageous for a corporation to issue notes, bonds or other evidence of indebtedness to its shareholders, rather than an increased amount of shares. Though the interest is taxable to the recipient, interest on a bona fide debt is deductible by the corporation, thus avoiding double taxation. (Of course, repayment of the principal is a tax-free return of capital.) [See *Indmar Products Co., Inc. v. Commr.* (6th Cir. 2006) 444 F3d 771, 776]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Comment: Interest income is taxed at ordinary rates, while dividend income is now taxed at the lower capital gain rates (¶ *2:103*). This may render corporate debt less attractive to some investors.

1) [2:108.1] **Market interest rate:** A shareholder's loan to a corporation should, like any other loan, bear a market rate of interest. A no-interest or below-market loan may be restructured by the IRS, leaving the shareholder with taxable "imputed interest" income. [IRC § 7872(a),(c)(1)(C); see *Estate of Hoffman v. Commr.* (4th Cir. 2001) 2001-1 USTC ¶ 50,401]

2) [2:108.2] **Caution—excessive debt:** But a disproportionately large amount of corporate debt may raise problems. The IRS may treat such debt as if it were part of the corporation's equity capital, and any interest or principal payments to the creditor-shareholders as "*constructive dividends*"—fully taxable to the shareholders and *not* deductible by the corporation. (Moreover, excessive shareholder debt may be subordinated to other creditor claims in the event of insolvency. *See* ¶ *3:30*.) [IRC § 385, *discussed at* ¶ *3:41*]

IRC § 163(j) limits the deduction of business interest expense for businesses with three-year average gross receipts of more than $29 million in 2023 and $30 million in 2024. For taxable years 2019 and 2020, corporations that, for three years, had annual gross receipts of more than $25 million (as indexed for inflation) could deduct an amount of interest that was no more than 50% of its EBITDA (earnings before interest, taxes, depreciation and amortization). In 2021, the limit decreased to 30% of EBITDA. This was further tightened in 2022, when the deductibility of corporate debt was capped at 30% of earnings before interest and taxes but after depreciation and amortization expenses. [IRC §§ 163(j)(1), (10), 448(c); Rev.Proc. 2023-34, 2023-48 IRB 1287; Rev.Proc. 2021-45, 2021-48 IRB 764]

(4) [2:109] **Retention of profits by corporation:** A corporation may wish to retain profits for future growth (*see* ¶ *2:180 ff.*). This may place corporations at an advantage over pass-through entities at certain income levels where corporations pay less tax. However, corporations desiring to retain earnings must consider some potentially major drawbacks:

(a) [2:110] **Penalty tax on personal holding company income:** In addition to the regular corporate tax, an onerous *20% penalty tax* may be imposed on earnings retained by small, closely-held corporations if the earnings are primarily passive income. [IRC § 541]

1) [2:111] **When applicable:** The penalty applies only if:

• More than 50% in value of the stock is held by 5 or fewer individuals at any time during the last half of the taxable year; and

• At least 60% of the corporation's income is from "passive" sources (dividends, interest, royalties), and in certain cases rents and personal service income. [IRC § 542] (Special attribution rules apply in determining "ownership" of stock for personal holding company purposes; see IRC § 544.)

2) [2:112] **Avoiding penalty:** The personal holding company penalty tax can be avoided by (i) increasing the amount of *operating* income, or (ii) electing Subchapter S status, in which event all corporate income is "passed through" to the shareholders (¶ *2:119*).

(The penalty tax could also be avoided by regular distribution of dividends, but this is rarely chosen because it results in double taxation of corporate profits, notwithstanding the taxation of dividends at lower capital gain rates; *see* ¶ *2:103*.)

(b) [2:113] **Penalty tax on "unreasonable" accumulations of earnings:** Another penalty tax applies to earnings accumulated in *excess of $250,000* and *beyond the reasonable needs of the corporation's business* ($150,000 for professional corporations). [IRC §§ 531-537; see generally, *Metro Leasing & Develop. Corp. v. Commr.* (9th Cir. 2004) 376 F3d 1015, 1021-1022]

Retained profits can be justified if held for "reasonable future anticipated needs"—e.g., working capital business expansion, contingent liabilities, repayment of outstanding debts, etc. However, the corporation must show, as of the end of each relevant year, a *specific, definite and feasible plan* to use the accumulation to meet the stated need *within a reasonable time*. [See Treas.Reg. § 1.537-1(a),(b); also see *Haffner's Service Stations, Inc. v. Commr.* (1st Cir. 2003) 326 F3d 1, 5-8—profits retained for possible redemption of dissident minority shareholders' stock not justified where corporation had no specific plan to redeem; compare *Advanced Delivery & Chemical Systems Nevada, Inc. v. Commr.*,

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

TC Memo 2003-250—board minutes and other documents showed corporation had sufficiently specific plan to use earnings for plant expansion and potential litigation re patent infringement and hazardous materials use]

(5) [2:114] **Deferral of income possibilities:** A corporation (other than an S corporation or a personal service corporation) may choose its own taxable year, without regard to the taxable year of its shareholders. This allows more opportunity for deferral of income than in a sole proprietorship or partnership. (Partnerships, personal service corporations and S corporations must adopt the tax year of their "principal owners," which generally means a calendar year and results in limited opportunity for income deferral; *see* ¶ *2:95, 2:150, 2:281.2*.)

(a) [2:115] **Dividend payment dates:** By deferring dividends to the calendar year following that in which the profits were earned, a corporation can effectively shift the tax burden of such dividends upon the shareholder from one year to the next, since dividends are taxable to shareholders only when *received*.

(b) [2:116] **Accruing expense payments to shareholders:** If the corporation reports on the *accrual basis*, it may *deduct* salaries, interest or other expenses payable to shareholders even if such expenses are not in fact paid until the following calendar year … thus giving it the benefit of a current deduction, while deferring shareholder liability for taxes on such payments to the following year.

1) [2:117] **Example:** Corporation adopts November 1 to October 31 fiscal year; awards $10,000 bonuses to its officer-shareholders on October 30, but does not in fact pay these bonuses until January 2 of the following year. The bonuses are deductible by the corporation in the fiscal year which ended October 31; but are not taxable to the officer-shareholders until the following year.

2) [2:118] **Limitation:** Salaries, interest, or other expenses payable to shareholders owning (directly or constructively) more than 50% in value of the corporation's stock may not be deducted until payment is actually made and income recognized by them. [IRC § 267(a)(2)]

(c) [2:118a] **Certain corporations precluded from using cash basis accounting:** C corporations with annual gross receipts over $30 million are prohibited from using the *cash method* of accounting for tax purposes. (This rule also applies to partnerships with any C corporation partners.) [IRC § 448; Rev.Proc. 2023-34, 2023-48 IRB 1287] This deprives such corporations of any potential flexibility afforded by the cash method, in which income is reported only as received and expenses reported only as paid.

(6) [2:118.1] **Double taxation on liquidating distributions:** Another major drawback to the corporate form is that a "double" tax may have to be paid when corporate assets are sold or distributed on liquidation: i.e., the corporation must pay a tax on any recognized gain and the shareholders may also recognize gain on receiving liquidating distributions. [IRC § 336; *see* ¶ *8:1151 ff.*]

As illustrated below (¶ 2:118.2 ff.), this factor should be considered carefully because it could have enormous tax consequences when the enterprise is dissolved.

(a) [2:118.2] **Example:** Assume the assets of XYZ Co. have appreciated by $1 million since they were acquired by the corporation.

• [2:118.2a] **Partnership, LLC or sole proprietorship:** Assuming all $1 million is taxed at the 20% maximum long-term capital gain rate, the *net after-tax profit* remaining for the owners would be *$800,000*.

• [2:118.2b] **Corporation:** If XYZ sells or distributes the assets to its shareholders in liquidation, the corporation would pay a tax of $210,000 (21% corporate rate) on the assumed $1 million gain. The shareholders would then pay a tax of $158,000 (20%) on the remaining $790,000 distributed to them (assuming this was all gain). As a result, the shareholders would be left with $632,000. (But if the investment in XYZ stock qualifies as "small business stock," all of the $790,000 gain may be *excluded* from income; *see* ¶ 2:100.2 ff.)

[2:118.2c - 2:118.2e] *Reserved.*

(b) [2:118.2f] **Distinguish—sale of stock:** Of course, the "double" tax can be avoided if, in lieu of a sale of assets by the corporation followed by a distribution of the proceeds to the shareholders, the shareholders simply sell their stock.

• [2:118.2g] **Example:** Thus, a sale of XYZ stock for $1 million, assuming a 20% long-term capital gain rate, would leave the shareholders with the same $800,000 that a partnership, LLC or sole proprietor would receive (¶ 2:118.2a). (But if the stock qualifies as "small business stock," all of the $1 million gain may be *excluded* from income; *see* ¶ 2:100.2 ff.)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

➪ [2:118.2h] ***PRACTICE POINTER:*** Most buyers prefer to purchase assets rather than stock in order to avoid potential claims against the corporate structure. (Also, a partnership, LLC or individual purchaser may have no need for the corporate structure.) Nevertheless, the sellers may be able to persuade the buyers to purchase stock by giving appropriate warranties and/or security to protect against any potential claims.

(7) [2:118.3] **“Passive activity” loss limitations:** The limitations on the deductibility by individuals of losses from “passive activities” (¶ *2:87.1 ff.*) also apply to certain closely-held corporations and “personal service corporations,” but on a significantly modified basis.

(a) [2:118.4] **Application to closely-held corporations:** The “passive activity” loss limitations apply to corporations in which *more than 50%* of the outstanding stock (by value) is owned directly or indirectly by *five or fewer* shareholders during the *last half* of the tax year. [IRC §§ 465(a)(1)(B), 469(j)(1), 542(a)(2); Treas.Reg. § 1.469-1T(g)(2)(ii) (temp.)]

(Thus, as a practical matter, the limitations do not apply to most publicly-held corporations.)

1) [2:118.5] **Deductibility of “passive activity” losses:** Closely-held corporations to which the “passive activity” loss limitations apply may offset their losses and credits from passive activities against *both* “passive activity” income and any other “net active income” (i.e., income from the corporation's other business activities).

However, such corporations may *not* deduct passive activity losses from “*portfolio income*” (i.e., dividends, interest, royalties, capital gains from investments, etc.). [IRC § 469(e)(2); Treas.Reg. § 1.469-1T(g)(4) (temp.)]

(*Compare:* Sole proprietors, LLC members and general and limited partners may only deduct “passive activity” losses from passive income, *not* from other active business income; ¶ *2:87.3, 2:93.2*.)

a) [2:118.6] **Example:** XYZ Corporation has $60,000 of passive losses, $50,000 of active business income and $10,000 of portfolio income. The $60,000 passive loss may be applied to reduce the active business income to zero, but the remaining $10,000 passive loss may not be deducted against the portfolio income.

➪ [2:118.7] ***PRACTICE POINTER:*** This makes the corporate form advantageous for enterprises engaged in multiple activities, some of which are passive and generate losses, and some of which are active operations generating taxable profits: The passive losses may be currently deducted against the profits. This may not be done by partners, LLC members or sole proprietors.

[2:118.8] ***Reserved.***

2) [2:118.9] **“Material participation” in activity—losses fully deductible:** Losses from an activity in which a corporation “*materially participates*” are “active” losses (¶ *2:87.2*) and are *fully* deductible (i.e., against passive, active and portfolio income).

3) [2:118.10] **Two tests for “material participation”:** Two different tests may be used to determine whether a closely-held corporation “materially participates” in an activity.

a) [2:118.11] **“Material participation” by majority shareholders:** “Material participation” will be found if one or more individual shareholders owning *more than 50%* (in value) of the corporation's stock materially participates in the activity—i.e., by being personally involved in it on a regular, continuous and substantial basis, or by satisfying any of the IRS “quantitative” tests for material participation (*see* ¶ 2:87.5 ff.). [IRC § 469(h)(4)(A); Treas.Reg. § 1.469-1T(g)(3) (temp.)]

Example: Assume that XYZ Corporation in the example at ¶ *2:118.6* has four shareholders, and that Shareholder X owns 60% of the value of the outstanding stock. If the $60,000 loss arose from activities in which Shareholder X materially participated, it is not “passive” and thus could be applied to XYZ's portfolio income (reducing it to 0).

b) [2:118.12] **Employee participation in activity:** “Material participation” by the corporation will also be found if the employee-participation and other requirements of IRC § 465(c)(7)(C)(i)-(iii) are met; i.e., if:

• At least one full-time employee devotes substantially all of the employee's services throughout the entire year to the active management of the activity;

• At least three full-time, nonowner employees devote substantially all of their services to the activity throughout the entire year; and

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Business deductions of the activity exceed 15% of the corporation's gross income for the year. [IRC § 469(h)(4)(B)]

4) [2:118.13] **Special rules for "rental activities":** *See ¶ 2:87.8.*

(b) [2:118.14] **Application to "personal service corporations":** The "passive activity" loss limitations also apply to "personal service corporations" (*see ¶ 2:229 ff.*). "Personal service corporation" is defined more broadly than usual for purposes of the passive activity loss limitations: It includes any corporation (other than an S corporation) whose:

• Principal activity is the performance of personal services which are substantially performed by the employee-owners for one *or more* clients or customers; *and*

• The employee-owners own collectively more than 10% (in value) of the stock. [IRC § 469(j)(2)]

(Compare: For tax avoidance purposes, a "personal service corporation" is one whose principal activity is providing the personal services of its employee-owners to *one* client or customer; IRC § 269A, *¶ 2:230.*)

1) [2:118.15] **Deductibility of "passive activity" losses:** A personal service corporation's "passive activity" losses are deductible only against passive activity income (the same as for individuals and partnerships; ¶ *2:87.3, 2:93.2*). [IRC § 469]

2) [2:118.16] **"Material participation":** Losses from an activity in which a personal service corporation "materially participates" are "active" losses and are fully deductible. [IRC § 469]

A personal service corporation "materially participates" in an activity if *one or more* shareholders with *more than 50%* (in value) of the corporation's stock materially participate (*¶ 2:87.5 ff.*). But unlike the regular C corporation, it may not qualify for material participation under the alternative employee-participation and other requirements of IRC § 465(c)(7)(C)(i)-(iii) (*¶ 2:118.12*). [IRC § 469(h)(4)]

e. [2:119] **S corporations:** An alternative approach to taxation of business income is to organize as a corporation but have the corporation elect to be taxed under Subchapter S of the IRC. [IRC §§ 1361-1379]

The effect is that the corporation will be *taxed like a partnership*. Each item of income and expense is "passed through" directly to the shareholders, and is not taxed at all at the corporate level. This gives the owners of closely-held corporations the advantages of the corporate form (e.g., centralized management, limited personal liability), while avoiding the double-taxation of corporate profits.

[2:120] **Compare—California law:** A corporation that is an S corporation under federal tax law is an S corporation under California tax law. Thus, profits and losses are "passed through" to the shareholders for state income tax purposes. However, a *1.5% franchise tax* is imposed on the S corporation's net taxable income. [Rev. & Tax.C. §§ 23801(a), 23802(b)(1); see *Valentino v. Franchise Tax Bd.* (2001) 87 CA4th 1284, 1288-1289, 1294, 105 CR2d 304, 307, 312; *Handlery Hotels, Inc. v. Franchise Tax Bd.* (1995) 39 CA4th 1360, 1363, 46 CR2d 525, 527]

Nonresident shareholders of a California S corporation are taxed on their share of the corporation's income that is attributable to California sources. [See Rev. & Tax.C. §§ 17041(b), 17951; *2009 Metropoulos Family Trust v. California Franchise Tax Bd.* (2022) 79 CA5th 245, 259, 294 CR3d 557, 561—nonresident shareholder trusts subject to California taxation on their distributive pro rata shares of S corporation's unitary business income (goodwill from sale of wholly owned subsidiary) that was sourced to California; *Valentino v. Franchise Tax Bd.*, supra, 87 CA4th at 1290-1296, 105 CR2d at 308-313]

A corporation filing a federal S election need not report the election to the Franchise Tax Board. (However, a corporation's *revocation* of its federal S election (*¶ 2:153*) must be timely reported to the Franchise Tax Board.) [See Rev. & Tax.C. § 23801(g)(2)]

(1) [2:121] **Advantages over regular corporation:** As stated, an S corporation pays no tax at the corporate level (except for a 1.5% corporate surtax in California, ¶ 2:120). Each item of corporate income and expense is "passed through" to the shareholders in exactly the same form as received by the corporation—i.e., as ordinary income or loss, capital gain or loss, tax credits, charitable contributions, etc. (*But see ¶ 2:132* re characterization of gains/losses on sales of property contributed by the shareholder to the corporation.) [IRC § 1366(b); see *Gitlitz v. Commr.* (2001) 531 US 206, 209, 121 S.Ct. 701, 704 & fn. 6—"The very purpose of Subchapter S is to tax at the shareholder level, not the corporate level";

Valentino v. Franchise Tax Bd. (2001) 87 CA4th 1284, 1288, 105 CR2d 304, 307; *Heller v. Franchise Tax Bd.* (1994) 21 CA4th 1730, 1736, 27 CR2d 88, 92 (citing text)]

(a) [2:122] **Losses "passed through" to shareholders:** Any ordinary business losses passed through to the shareholders can be used to offset their other taxable income, subject to basis limitations and "passive activity" loss limitations discussed below (¶ 2:123 ff.).

1) [2:122.1] **Tax planning:** This makes an S corporation particularly attractive to investors in new businesses. Start-up businesses are likely to generate operating losses. These losses get "passed through" to the shareholders … so that they can deduct them against other income, subject to basis limitations and the "passive activity" loss limitations. And, if the business is profitable, the taxable earnings "pass through" to the shareholders to be taxed at their individual (and potentially lower) rates (*see ¶ 2:99 ff.*).

2) [2:123] **"Passive activity" loss limitation:** Since an S corporation shareholder is taxed on an individual basis, the shareholder can only deduct losses from "passive" activities (i.e., activities in which the shareholder does not "materially participate") against passive activity income (*see ¶ 2:87.1 ff.*).

The test for "material participation" is the same as for an individual or general partner: The S corporation shareholder must *personally* be involved in the corporation's activity on a *regular, continuous, substantial basis throughout the tax year* (*see ¶ 2:87.5*). If this test is met, the shareholder may fully deduct their share of the S corporation's losses against any other taxable income (i.e., passive, active and portfolio income; *see ¶ 2:87.3*). [IRC § 469]

3) [2:124] **Basis limitation on loss write-offs:** Shareholders in an S corporation can write off its operating losses only to the extent of their investment in shares *or loans* to the corporation. (E.g., if the total investment is $10,000, no more than $10,000 in "passed through" operating losses can be deducted by the shareholders.) But while losses in excess of that amount cannot be deducted, they can be *carried forward* to *future tax years* and applied against any profits earned by the corporation, or against additional investments made by the shareholders. [IRC § 1366(d); Treas.Reg. § 1.1366-2; see *Gitlitz v. Commr.* (2001) 531 US 206, 209-210, 121 S.Ct. 701, 704]

However, any "passed through" operating losses *reduce the basis* of the shareholder's stock and corporate debts (but not below zero), in that order. This prevents double deductions—i.e., one deduction for operating loss and another for capital loss on sale of the stock. [IRC § 1367(a)(2) & (b)(2); and see *Hudspeth v. Commr.* (9th Cir. 1990) 914 F2d 1207, 1211-1212—"tax benefit rule" no bar to basis reduction even though taxpayers did not receive tax benefit for full amount of their pro rata share of loss]

a) [2:124a] **Requirements for loans:** A loan can increase a shareholder's basis in S corporation stock only to the extent it is "bona fide indebtedness of the S corporation that runs directly to the shareholder." Whether a loan satisfies this requirement is determined under general federal tax principles based on all the facts and circumstances. [Treas.Reg. § 1.1366-2(a)(2)(i) & (iii)]

b) [2:124.1] **Shareholder "guaranty" of S corporation loans to increase basis:** A shareholder cannot increase their basis simply by guarantying third-party loans to the corporation. [Treas.Reg. § 1.1366-2(a)(2)(ii); see *Maloof v. Commr.* (6th Cir. 2006) 456 F3d 645, 650; *Phillips v. Commr.*, TC Memo 2017-61—tax basis not increased by amount of unpaid judgment obtained by creditor who sued on guaranty]

But the shareholder's basis may be increased by the amount of any *payment* the shareholder makes pursuant to the guaranty. [Treas.Reg. § 1.1366-2(a)(2)(ii); *Montgomery v. Commr.*, TC Memo 2013-151; see *Franklin v. Commr.*, TC Memo 2016-207—creditor's seizure and sale of S corporation shareholder's personal assets to satisfy guaranty of corporate debt increased basis by value of seized assets]

1/ [2:124.2] **Compare—bona fide loan using third party funds:** The shareholder may increase their basis by, in substance, borrowing funds from a third party and loaning them to the corporation. The key is that the third party must view (and the documentation must establish) the shareholder as the *primary obligor*—i.e., just as if the shareholder's credit were extended to the corporation. [See *Bolding v. Commr.* (5th Cir. 1997) 117 F3d 270, 273-274]

2/ [2:124.3] **Limitation—loans from other shareholders excluded from basis:** Amounts borrowed from a third party and loaned to the corporation will *not* increase the shareholder's basis in their S corporation stock if the third party is *another shareholder* (or a person "related" to another shareholder) in the S corporation. This

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

is so even where the borrowing shareholder is regarded as primary obligor on the loan. [IRC § 465(b)(3)(A); *Van Wyk v. Commr.* (1999) 113 TC 440]

➪ [2:125] ***PRACTICE POINTER:*** An S corporation shareholder needs sufficient *basis* against which to deduct whatever losses the shareholder is able to deduct. If your clients are planning to use an S corporation's losses as a write-off against their other income (subject to the "passive activity" loss limitations, ¶ 2:123), be sure they contribute sufficient capital and loans to the corporation to cover its potential operating losses. Otherwise, they will be unable to write off all those operating losses.

[2:125a - 2:125d] ***Reserved.***

c) [2:125e] **Third-party loan secured by shareholder's property:** Third-party loans to the S corporation secured by the shareholder's property—*other than property used in the business*—can increase the shareholder's basis in the S corporation stock. [See IRC § 465(b)(2)(B)]

1/ [2:125f] **Pledge of S corporation stock:** Stock in the S corporation (or a related corporation) is treated as *property used in the business*; thus, a loan secured by a pledge of the stock of the S corporation (or a related corporation) will *not* increase the shareholder's basis against which losses may be deducted. [*Broz v. Commr.* (2011) 137 TC 46, 63-64, aff'd (6th Cir. 2013) 727 F3d 621, 625-629—"where the transaction has been structured so as to remove any realistic possibility of loss, the taxpayer is not at risk for the borrowed amounts"]

4) [2:125.1] **No loss carryovers between C and S years:** If a C corporation converts to an S corporation, neither the corporation nor its shareholders may claim a carryover deduction for losses arising when the entity was a C corporation. This prohibition is effective for so long as the corporation retains S status. [IRC § 1371(b); see also *Rosenberg v. Commr.* (1991) 96 TC 451—shareholder could not avoid § 1371(b) prohibition by characterizing net operating loss as "tax benefit" income exclusion]

➪ [2:125.2] ***PRACTICE POINTER:*** If there is any realistic possibility that a corporation will experience initial operating losses, it should seriously consider electing S status at the onset. A C corporation's losses cannot be utilized by converting to an S corporation, and a conversion may have other adverse consequences (*see ¶ 2:128.2*).

[2:125.3 - 2:125.4] ***Reserved.***

5) [2:125.5] **Section 1244 not available to S corporation as shareholder:** S corporations that sustain losses in investments in the stock of small business corporations ("§ 1244 stock") *cannot* utilize the ordinary loss deduction afforded by IRC § 1244. Hence, no § 1244 ordinary losses are passed through to their shareholders. [*Rath v. Commr.* (1993) 101 TC 196 (disagreed with on other grounds in *Estate of McLendon v. Commr.* (5th Cir. 1998) 135 F3d 1017, 1023, fn. 11)]

(b) [2:126] **Profits taxable at individual shareholder rates:** An S corporation's profits, like its losses (*¶ 2:122 ff.*), "flow through" to its shareholders *in proportion* to their stock ownership throughout the year, to be taxed at the shareholders' individual rates (with a corresponding increase in their stock basis; see IRC § 1367(a)(1)). [IRC § 1366(a)]

1) [2:126.1] **Income taxed whether or not distributed:** As with a partnership, corporate income is taxed to the shareholders *whether or not actually distributed* to them. This often makes it impractical to retain high earnings in the business, since there is great pressure to distribute at least a portion of the earnings sufficient to cover the shareholders' tax liability. [See *Valentino v. Franchise Tax Bd.* (2001) 87 CA4th 1284, 1289, 1291, 105 CR2d 304, 307, 309]

(Of course, one benefit of this "automatic pass-through" is that S corporations are not subject to the accumulated earnings penalty tax; *see ¶ 2:113.*)

a) [2:126.1a] **Income taxed to beneficial owner:** Ordinarily, corporate income "passes through" and is taxed to the shareholder *of record*. However, a person who does *not* hold record ownership may nevertheless be treated as the shareholder for S corporation purposes if the person is a *beneficial* owner of the shares under state corporate law. [See *Pahl v. Commr.* (9th Cir. 1998) 150 F3d 1124, 1128-1129—lawyer who joined law firm organized as S corporation but withdrew without paying for shares was treated as beneficial shareholder for S corporation tax purposes and thus subject to reporting pro rata share of profits; also see *Feraco v. Commr.*, TC Memo 2000-312]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[2:126.1b - 2:126.1d] ***Reserved.***

2) [2:126.1e] **Exception for former C corporations with passive income:** An S corporation having accumulated earnings and profits from prior tax years when the corporation was a C corporation may be subject to a special "sting" tax: If more than 25% of its gross receipts are passive investment income (e.g., rents, most dividends), the excess is taxed at the highest corporate tax rate (21%). [IRC § 1375(a)]

Moreover, the corporation's S election automatically terminates if the corporation has accumulated earnings and profits at the close of three consecutive taxable years *and* if more than 25% of its gross receipts in each of those years is passive investment income. [IRC § 1362(d)(3)]

a) [2:126.1f] **Distinguish—dividends received from subsidiary:** Dividends received by an S corporation from a C corporation subsidiary are *not* treated as passive investment income to the extent the C corporation's earnings and profits are derived from the *active* conduct of a trade or business. [IRC § 1362(d)(3)(E)]

3) [2:126.2] **Potential 20% deduction for "qualified business income":** S corporation shareholders, like owners of other pass-through entities, may deduct up to 20% of "qualified business income" earned from the S corporation. *See ¶ 2:88 ff.*

4) [2:126.3] **S and C corporations compared:** For income tax purposes, the S corporation is analogous to a sole proprietorship, partnership or LLC.

Although a C corporation can avoid corporate taxes by distributing all of its profits to its shareholders in the form of salaries, bonuses, rent, etc., bear in mind that *excessive compensation* may be treated as constructive dividends (*see ¶ 2:106*). Also, both the corporation and its shareholders will be taxed when the corporation's assets are sold or liquidated (*see ¶ 2:128.1*). For these reasons, the S corporation should be carefully considered.

(c) [2:127] **Safe method for distribution of profits:** An S corporation also makes sense where the owners want to distribute most of the net profits, and such income would be taxed to either the corporation or individual shareholders at *roughly* the same effective tax rates.

An S corporation may also be desirable where the owners are not all active enough in the business to justify withdrawing profits as "deductible salaries."

But the corporate distribution to owners will be taxed again—as a dividend (*¶ 2:103*). And there is always a risk the IRS may challenge large salaries, interest or other expense deductions claimed by the corporation on distributions to its shareholders, particularly if they are not active in the business. (The IRS may claim these are "constructive dividends" and seek to impose double taxation on the profits so distributed; *see ¶ 2:106*.)

However, by filing as an S corporation, these risks are eliminated. All corporate income is "passed through" proportionately to the shareholders, and therefore there is no possibility of salaries or other payments being challenged as "constructive dividends" to the shareholders.

1) [2:128] **Limitation—no avoidance of employment taxes:** However, this cannot be used to avoid payment of employment taxes—i.e., where the principals render services to the corporation, they cannot simply draw out all of the corporate profits as "dividends," without paying themselves salaries. The IRS takes the position that an S corporation *must* pay reasonable salaries to those shareholders rendering services, and must withhold payroll taxes, and pay federal employment taxes (FICA, FUTA, etc.). [Rev.Rul. 74-44, 1974-1 CB 287]

Indeed, the IRC and Treasury Regulations define "employee" for FICA and FUTA purposes as including "any officer of a corporation" … except those who perform only minor or no services for the corporation and who neither receive nor are entitled to receive any remuneration. [IRC § 3121(d); Treas.Reg. § 31.3121(d)-1(b); see also *Spicer Accounting, Inc. v. United States* (9th Cir. 1990) 918 F2d 90, 92-93—dividends paid to stockholder who performed "substantial services" for S corp. deemed "wages" subject to FICA and FUTA]

(d) [2:128.1] **Avoid "double tax" on liquidating sale or distribution of corporate assets:** By electing S corporation status, the shareholders can avoid two levels of tax on the sale or distribution to themselves of the corporation's assets upon liquidation: The gain (or loss) on such liquidating sales or distributions will "pass through" to the shareholders to be taxed *once* (*see ¶ 8:1151 ff.*).

1) [2:128.2] **Caution—converting from C to S status:** However, a C corporation converting to S corporation status will *not* avoid corporate-level tax on "built-in" gains—i.e., gains (appreciation of assets) that arose *before* conversion,

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

if recognized by the S corporation, either through sale or distribution to the shareholders, within *five years* after electing S status. Gains on sales or distributions within the five-year period are *presumed* to be "built-in" gains, unless the taxpayer establishes otherwise. [IRC § 1374; and see Announcement 86-128, 1986-51 IRB 22]

(e) [2:129] **"Passive income"; limitations:** Corporations electing Subchapter S status generally can have unlimited income from so-called "passive" sources (e.g., rents, royalties, interest, dividends, etc.) without jeopardizing their S status. (This may encourage S corporation use for real estate ventures, tax shelters, etc.)

However, there is a limitation where the corporation has *accumulated earnings and profits* from prior tax years when it was a C corporation; *see ¶ 2:126.1e*.

(f) [2:130] **Treatment of subsidiaries:** An S corporation, like a C corporation, may own stock in other corporations; but there are some important differences in the way S corporation parents and subsidiaries are treated.

1) [2:130.1] **S corporation subsidiary:** An S corporation that owns *all* of the stock of another S corporation may elect to disregard the subsidiary's separate existence for federal income tax purposes. All assets, liabilities, and items of income, deduction and credit of the subsidiary are treated as belonging to the parent. [IRC § 1361(b)(3)(A) & (B); Treas.Reg. §§ 1.1361-2, 1.1361-3, 1.1361-4(a)(1)]

a) [2:130.2] **Termination of election:** If the parent fails to own all of the stock of its S corporation subsidiary, or if it terminates its election to disregard the subsidiary's separate tax existence, the subsidiary is treated as a *new C corporation* that acquired all of its assets and liabilities from the S corporation in exchange for its stock. Unless the exchange qualifies for nontaxable treatment (e.g., under IRC § 351; *see* ¶ *2:160 ff., 3:331 ff.*), there may be adverse tax consequences *in addition to* taxation of the subsidiary as a C corporation. [IRC § 1361(b)(3)(C); Treas.Reg. § 1.1361-5(a),(b)]

Moreover, the subsidiary is barred from electing to be treated as an S corporation for a period of *five years* after the termination (unless the IRS consents to the election). [IRC § 1361(b)(3)(D)]

b) [2:130.3] **Caution—no "partial" S corporation subsidiary:** An S corporation cannot own less than all the stock of another S corporation … because the subsidiary's stock ownership does not satisfy the requirements for S corporation shareholders (*¶ 2:144*). [See Treas.Reg. § 1.1361-2(a)(1)]

Thus, a wholly-owned S corporation subsidiary that issues stock to someone other than its parent (e.g., an employee) will become a C corporation.

2) [2:130.4] **C corporation subsidiary:** An S corporation may own any amount (even 100%) of the stock of a C corporation. However, an S corporation cannot file a consolidated return with its C corporation subsidiaries. [IRC §§ 1361(b), 1504(b)(8)]

[2:130.5 - 2:130.9] ***Reserved.***

(g) [2:130.10] **Compare—no deduction for dividends received:** The deduction from corporate income for dividends received from other corporations (see IRC §§ 243, 245) does *not apply to S corporations*. Since an S corporation generally computes its earnings as an individual and not as a corporation, it may not deduct items such as corporate dividends that are deductible only by corporations. [See *Naporano v. United States* (D NJ 1993) 834 F.Supp. 694, 703-704—deduction from corporate income for foreign sales corporation dividends (IRC § 245(c)(1)) not applicable to S corporations]

(h) [2:131] **Compare—limitation on certain fringe benefits:** S corporation employee-shareholders do *not* receive tax-favored treatment for fringe benefits (other than retirement plans) if they own *more than 2%* of the outstanding stock. Benefits such as life, health and accident insurance, and medical expense reimbursement plans (*see ¶ 2:215 ff.*), will be currently taxable to such shareholders (just as if they were partners in a partnership) and may not be deducted by the S corporation. [IRC § 1372]

(i) [2:132] ***Caution—gain/loss on property contributed by shareholder and later sold by corporation:*** As stated above (*¶ 2:121*), the *characterization* of passed-through corporate income and losses—including gains and losses from the *sale or exchange of corporate property*—is the same at the shareholder level as at the corporate level.

However, there is an *exception* for gains and losses attributable to property *contributed by the shareholder to the corporation*: If the S corporation is formed or availed of by a shareholder for a principal purpose of selling or exchanging the property to alter the character of the gain or loss that would have been realized had the property been

sold *by the shareholder* (i.e., change ordinary gain into capital gain or capital loss into ordinary loss), the character of the gain or loss remains what it would have been if the property had been sold or transferred by the shareholder. [Treas.Reg. § 1.1366-1(b)]

[2:133] ***Reserved.***

(2) [2:134] **S corporation compared to partnership and LLC:** Although S corporations, partnerships and LLCs have many of the same tax attributes, there are some significant differences.

(a) [2:135] **S corporation advantageous as investment vehicle:** Some of the risks and disadvantages of investments in partnerships and LLCs can be avoided through an S corporation:

[2:136] ***Reserved.***

1) [2:137] **No personal liability for business debts** (while not a risk for LLC members, it is a risk for general partners, as well as limited partners who take an active role in the business; *see ¶ 2:27*).

2) [2:138] **Continuity** (partnership and LLC may terminate upon sale or exchange of ownership interests).

3) [2:138.1] **Transferability** (general partnership interests are not readily transferable, and transfer of limited partnership or LLC member interests usually must be restricted to preserve pass-through tax treatment; even where S corporation shareholders have a buy-sell agreement, there is greater flexibility in allowing transfers).

4) [2:138.2] **One shareholder permitted** (though LLCs also permit as few as one member, partnerships require at least *two* owners).

5) [2:139] **Management and control** (general partners share management and control powers, while limited partners usually have none; LLC can have centralized management, but cannot switch between centralized and noncentralized management without amending articles; S corporation shareholders have maximum flexibility and can manage or not at will).

(b) [2:140] **Partnership or LLC advantageous for loss write-offs:** If a new business is expected to generate operating losses, a partnership or LLC may be more advantageous than a corporation. This is because S shareholders cannot write off losses exceeding their actual investments (in shares or loans to the corporation; *see ¶ 2:124*). On the other hand, partners can write off losses equaling their investment *plus* any other amounts for which they are "at risk"; and LLC members can write off losses equaling their investment *plus* their allocable share of LLC debt (*see ¶ 2:97.19 ff.*).

Moreover, partners in *real estate limited partnerships* can include their share of certain "nonrecourse" mortgage debt in determining the amount of their investments (*see ¶ 2:92*); this makes S corporations generally unsuitable for real estate investments.

(c) [2:141] **Partnership or LLC advantageous for allocating profits and losses:** Another possible advantage of the partnership or LLC is more flexibility in sharing profits and losses. With an S corporation, profits and losses are allocated among the shareholders in proportion to their stock ownership throughout the year. In contrast, subject to rather stringent limitations (see Treas.Reg. § 1.704-1), partners and LLC members can agree to allocate profits and losses disproportionately; and often allocate profits on one basis and losses on another (*see ¶ 2:13*).

This flexibility may be especially useful due to the "passive activity" loss limitations (*¶ 2:87.1 ff.*): Passive income may be allocated to those partners or LLC members who need it to offset other passive losses; and passive losses could be allocated to partners or LLC members with excess passive income from other activities.

(d) [2:141.1] **Partnership and LLC avoidance of S corporation restrictions:** Certain restrictions applicable to S corporations do *not* apply to partnerships or LLCs:

• No limit on number of partners or members (S corporations are limited to 100 shareholders; *see ¶ 2:143*).

• S corporation shareholders are restricted to individuals (except nonresident aliens may *not* own stock), estates, certain trusts, charitable organizations and partnerships acting as mere nominees for eligible S corporation shareholders (*see ¶ 2:144*). In contrast, any person or entity (including any partnership, LLC or corporation) can be a partner or LLC member.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• S corporations limited to one class of stock (*see ¶ 2:145 ff.*), while partnerships and LLCs can have different classes of partnership/membership interests.

• Partnerships and LLCs need not file an election to attain pass-through treatment (cf. *¶ 2:148 ff.*).

• No consideration required for partnership interests (*see ¶ 2:29*), and LLC membership can be acquired for future services or any other obligation, including a promise to pay. By contrast, corporate stock cannot be issued for future services or an unsecured promise to pay (*see ¶ 3:308*).

• Unlike S corporations, LLCs and partnerships are *not* required to observe prescribed formalities (e.g., meetings, resolutions, etc.).

(3) [2:142] **Requirements for S status:** To file as an S corporation, the corporation must meet the following basic requirements:

(a) [2:143] **No more than 100 shareholders:** First of all, an S corporation is limited to 100 shareholders (but most family members may be counted as one shareholder; *see ¶ 2:144a*). [IRC § 1361(b)(1)(A)]

1) [2:144] **Kinds of shareholders:** Only the following persons/entities may hold stock in an S corporation:

• *Individuals* who are citizens or resident aliens (i.e., nonresident aliens may *not* own stock);

• Estates;

• Certain kinds of trusts;

• Another S corporation, but only if the other S corporation is the *sole shareholder* (*see ¶ 2:130.1*);

• A partnership, but only if the partnership is acting as a *mere nominee* for a person who qualifies as an S corporation shareholder (Treas.Reg. § 1.1361-1(e)(1)); and

• Tax-exempt charitable organizations. [IRC § 1361(b),(c); see *Taproot Administrative Services, Inc. v. Commr.* (9th Cir. 2012) 679 F3d 1109, 1116-1117—neither IRA nor Roth IRA may be S corporation shareholder]

2) [2:144a] **Spouses and family members treated as one shareholder:** For purposes of the 100-shareholder limit, spouses (and their estates) holding shares are counted as one. [IRC § 1361(c)(1)(A)(i)]

Similarly, all members of a family (and their estates) are counted as one. (Generally, members of a family for purposes of the 100-shareholder limit include all those related by up to *six generations* from a common ancestor.) [IRC § 1361(c)(1)(A)(ii), (B)]

3) [2:144.1] **Partnership composed of S corporations can avoid shareholder limit:** A business may be operated by a partnership composed of several S corporations … even where the principal purpose for forming the corporations was to avoid the 100-shareholder limit. Reason: The purpose of the shareholder limit is to obtain *administrative simplicity* in the corporation's tax affairs; and the corporation's participation in a partnership does *not* increase administrative complexity at the S corporation level. [Rev.Rul. 94-43, 1994-2 CB 198 (issued under former 75-shareholder limit)]

(b) [2:145] **Single class of stock (except as to voting rights):** An S corporation can have only one class of stock outstanding (i.e., common) so that each shareholder has the same rights to share in the profits and assets of the corporation. But certain shares may have exclusive or greater *voting rights* than others (this assures S corporations of sufficient flexibility re management and control). This may include giving some shareholders veto power over share transfers by other shareholders (e.g., through a shareholders' buy-out agreement; *¶ 3:187 ff.*). [IRC § 1361(b)(1)(D),(c)(4); Treas.Reg. § 1.1361-1(*l*)(1)(2)(iii)]

Other than as to voting rights, however, no distinctions may exist among the shares or shareholders; e.g., no priorities as to dividends, liquidation rights, etc. [IRC § 1361(c)(4)]

1) [2:146] **Restrictions on certain shares may be deemed to create second class of stock:** Restrictions on dividends or liquidation rights of certain shares in favor of other shares may be deemed to create a second class of stock—

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

thus disqualifying the corporation from electing S status. It makes no difference that such restrictions result from agreements among the shareholders; or even that they were imposed by *securities law requirements*. [See *Paige v. United States* (9th Cir. 1978) 580 F2d 960, 962-964—limitations imposed by California Corporations Commissioner held to create a second class of shares, preventing S status; and Treas.Reg. § 1.1361-1(*l*)(2)(v), Ex. 1]

2) [2:147] **Certain debt instruments may be treated as second class of stock:** There is a safe harbor for "straight debt" evidenced in writing (see IRC § 1361(c)(5)). But shareholder loans to the corporation that are *contingent* as to repayment (e.g., interest or principal payments contingent on profits earned, or at discretion of board) may be treated as equity, and hence a second class of stock, disqualifying the corporation from electing S status. Likewise, shareholder loans that are *convertible* into stock may be treated as a second class of stock. [See IRC § 1361(c)(5); Treas.Reg. § 1.1361-1(*l*)(5) & (4)(iv)]

(c) [2:148] **Timely election required:** To be effective for the current year, a corporation must file its S corporation election *not later than 2 months and 15 days after the first day* of the taxable year; i.e., it cannot wait until the close of the year to decide. [IRC § 1362(b); see *Handlery Hotels, Inc. v. Franchise Tax Bd.* (1995) 39 CA4th 1360, 1365, 46 CR2d 525, 528—election effective for Calif. tax purposes in income year in which election made]

Cross-refer: The procedure for filing is discussed at ¶ *4:481*.

1) [2:149] **When taxable year begins:** For purposes of determining when the S corporation election must be made, a *new* corporation's taxable year is deemed to begin on the *earliest* date it (a) has shareholders, (b) acquires any assets, or (c) begins to do business. [Treas.Reg. § 1.1362-6(a)(2); *see* ¶ *4:482 ff.*]

a) [2:149.1] **Compare—"taxable year" for tax reporting purposes:** *See* ¶ *2:150 ff.*

2) [2:149.2] **Shareholder consents required:** The S election requires the consent of all existing shareholders, and any persons who *were* shareholders earlier in the year. [IRC § 1362(a)(2) & (b)(2); Treas.Reg. § 1.1362-6(a)(2)]

If the stock (or income from the stock) is *community property*, the shareholder's *spouse* must also consent to the election. [Treas.Reg. § 1.1362-6(b)(2)(i)]

(4) [2:150] **Fiscal year for S corporations:** Like partnerships, S corporations must use a *calendar* year for tax reporting purposes. Rev.Proc. 2006-46 provides for automatic procedures for a partnership, S corporation or electing S corporation and a personal service corporation to change its tax year. An entity that cannot file under the automatic procedures must file under the nonautomatic procedures and establish a business purpose to obtain the approval of the IRS for its requested change of tax year. [Rev.Proc. 2002-39; IRC § 1378; and see IRC § 706 (*discussed at* ¶ *2:95*)]

(a) [2:151] **Three-month deferral election:** An S corporation may elect to adopt a different taxable year so long as this does not result in more than a three-month deferral of income to the shareholders—thus facilitating September, October and November year-ends. But the S corporation must make prescribed estimated tax payments every April 15 or risk losing its deferral election. [IRC § 444(c)]

(5) [2:152] **Termination of S status:** Once a timely election is filed, S status continues until terminated either by the corporation's revocation of its election, or by its otherwise becoming disqualified as a small business corporation under Subchapter S.

(a) [2:153] **Revocation of election:** The corporation's election to be taxed as an S corporation may be revoked any time *before* the deadline for filing an S election (i.e., any time prior to the 15th day of the third month of the corporation's tax year) by those persons who, on the day the revocation is made, hold a majority of the outstanding shares (including nonvoting shares). [IRC § 1362(d); Treas.Reg. § 1.1362-2(a)(1); see Treas.Reg. § 1.1362-6(a)(3) re requirements for filing statement of revocation]

1) [2:153.1] **Effective date:** If filed within the deadline, the revocation is effective for the *entire* taxable year. However, the shareholders may revoke an S election for *part* of the current year (instead of the entire year) by specifying some future date for the revocation to take effect. (This is sometimes called "pro-active revocation.")

A revocation filed *after* the deadline is too late to break the election for the current year to date, but will prevent S status in following years. [IRC § 1362(d)]

(b) [2:154] **Disqualification as S corporation:** S status terminates automatically if the corporation fails to meet the S corporation requirements (¶ *2:142 ff.*). For example, the issuance of shares to more than 100 shareholders or to a nonqualifying corporate shareholder, or the issuance of a second class of shares, can terminate unwanted S status at any time during the year. (Also, there is automatic termination when passive investment income exceeds 25% of gross

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

receipts for three consecutive years if the corporation has retained earnings from when it was a C corporation; *see ¶ 2:126.1e*.) [IRC § 1362(d); see *Taproot Administrative Services, Inc. v. Commr.* (9th Cir. 2012) 679 F3d 1109, 1111, fn. 1; compare *Mourad v. Commr.* (1st Cir. 2004) 387 F3d 27, 29-31—bankruptcy of S corporation and appointment of trustee did not automatically terminate S status]

1) [2:155] **When effective:** In such cases, the S status terminates only as of the date of the disqualifying event (it is *not retroactive* to the beginning of the year). [See Treas.Reg. § 1.1362-2(b)(2)]

A short-year tax return as an S corporation is still required, and a written notification should be attached to the return stating a termination occurred and giving the termination date. [IRC § 1362(e); Treas.Reg. § 1.1362-2(b)(1)]

2) [2:156] **Ban on renewed election; reinstatement following inadvertent termination:** Following such termination of S status, a corporation may not file another S election for 5 years. [IRC § 1362(g); see Treas.Reg. § 1.1362-5(a)]

However, if the earlier termination was "inadvertent," the IRS may allow the corporation to "reinstate" its S status after the disqualifying events have been undone. To do this, the corporation must submit a ruling request setting forth the events that caused the termination, how the events were discovered, and the remedial steps taken by the corporation to cure the inadvertent termination. [IRC § 1362(f); see, e.g., Priv.Ltr.Rul. 201902013]

2. [2:157] **Taxation of Transfers to Business Entity:** Consideration must be given to whether the investors will be subject to tax liability by reason of investing or transferring assets to the new business entity. There is no tax liability involved with investing cash, but there *may* be taxes payable on account of transfers of *noncash* assets (e.g., assets of a going business) to a *corporation* in exchange for its securities, unless the transaction is structured as a tax-free exchange (¶ 2:159 ff.).

a. [2:158] **Partnerships and LLCs:** Contributions of cash or noncash assets to a pass-through entity are generally tax-free, both to the entity and to the owners individually. Noncash assets (equipment, inventory, assets of going business, etc.) retain the same basis in the hands of the entity that they had in the hands of the contributors. [IRC § 721]

(1) [2:158.1] **Compare—interests granted for services rendered:** Interests granted to promoters, underwriters, syndicators, general partners, etc. in exchange for services rendered in organizing a partnership or LLC may be taxable as *ordinary income:*

• [2:158.2] An interest in partnership or LLC *capital* is clearly taxable. [See Treas.Reg. § 1.721-1(b)(1)]

• [2:158.3] In contrast, a *future profits* interest in a partnership (and in an LLC taxed as a partnership) is *not* taxable, *except where* (i) the profits interest relates to a "substantially certain predictable income from high-quality debt securities or a high-quality net lease," (ii) the partner disposes of the interest within two years, *or* (iii) the interest is an interest in a "publicly traded partnership" (IRC § 7704(b)). [See Rev.Proc. 93-27, 1993-2 CB 343 (superseding *Campbell v. Commr.* (8th Cir. 1991) 943 F2d 815); *and ¶ 2:171*]

(a) [2:158.4] **Potential capital gain treatment:** Certain partnership or LLC profits interests received in return for the performance of services and held for at least *three years* may be taxable as long-term capital gain rather than as ordinary income. [See IRC § 1061]

Cross-refer: For a detailed discussion of taxation of transfers to partnerships and LLCs, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 8.

b. [2:159] **Corporations:** Neither gain nor loss is recognized by a corporation when it issues its securities in exchange for cash or property. [IRC § 1032]

Nor do investors (shareholders) recognize gain or loss on paying cash for corporate stock or securities. However, if they transfer *noncash* assets for such stock or securities, their investment may be treated as a sale or exchange of those assets. Gain will be recognized to the extent the fair market value of the stock or securities received from the corporation exceeds the basis of the assets transferred … *unless* the transaction is structured as a *tax-free exchange* under IRC § 351.

c. [2:160] **Requirements for tax-free incorporation (IRC § 351):** Transfers of noncash assets to a corporation are nontaxable when:

• The "property" is exchanged "solely for stock"; *and*

• Immediately after the exchange, the transferors "control" the corporation (owning at least 80% of all stock outstanding, voting and nonvoting). [IRC § 351, *see detailed discussion at ¶ 3:331 ff.*]

(1) [2:161] **“Property”:** The first requirement is that there be a transfer of “property” to the corporation … as distinguished from *services*. [IRC § 351(a); *see* ¶ *3:333, 3:349*]

(a) [2:162] **Compare—taxation of services:** *See* ¶ *2:171*.

(2) [2:163] **“Solely for stock”:** The property must be transferred to the corporation *solely* in exchange for the corporation's stock. Other securities (e.g., debt instruments, preferred stock functionally equivalent to debt) and any cash or other consideration paid by the corporation for the property are treated as “boot”; and taxable gain on such “boot” is recognized by the investor at the time of the transfer. [IRC § 351(b); *see* ¶ *3:337 ff.*]

(a) [2:164] **Taxable “boot”:** *See* ¶ *3:340*.

(b) [2:165] **Assumption of liabilities as “boot”:** *See* ¶ *3:343*.

(3) [2:166] **“Control”:** Immediately after the transfer, the transferors must own at least 80% of all outstanding shares of all classes of the corporation's stock. [IRC § 368(c); *see* ¶ *3:346*]

(4) [2:167] **Planning considerations:** A transfer of noncash assets to a corporation that meets the above requirements is a tax-free exchange under IRC § 351—whether or not elected by the transferors. Tax-free treatment may not always be the most advantageous for the organizers of a new business—i.e., there may be advantages to recognizing and paying tax at the time of the transfer, in order for the corporation to obtain a stepped-up basis on the assets invested. *See “Advantages v. Disadvantages of Tax-Free Incorporation,”* ¶ *3:359*.

(5) [2:168] **Compare—*conversion into corporation:*** Conversion of an existing partnership or LLC into a corporation may likewise qualify for tax-free treatment under IRC § 351; *see* ¶ *8:538*.

[2:169 - 2:170] ***Reserved.***

d. [2:171] **Compare—taxation of services contributed to new business:** As stated above (¶ 2:158.1), shares issued for services rendered do *not* qualify for tax-free treatment under IRC § 351. And, the same rule applies to interests in *partnership or LLC capital* (but not interests in *future profits*) granted in return for services rendered or to be rendered. In such cases, the recipient of the stock or interest is treated as having received compensation—i.e., ordinary income—in the amount of the fair value of the stock or interest received. [IRC § 83; see *Theophilos v. Commr.* (9th Cir. 1996) 85 F3d 440, 445—contract to acquire stock constitutes taxable compensation under IRC § 83]

(1) [2:172] **Effect:** The result, of course, is that the recipient ends up having to pay taxes in the year the stock or other capital interest is received—although they may not have received any cash with which to pay.

➪ [2:173] ***PRACTICE POINTER:*** Because of this adverse tax effect, *consider other arrangements* for compensating those whose services are being contributed to the venture: e.g., instead of issuing them stock, consider paying them salaries, or giving them a contract right to share in future profits.

[2:173.1 - 2:173.4] ***Reserved.***

(2) [2:173.5] **Deduction by corporation:** A corporation that issues shares for services can deduct an amount equal to the amount “included” by the stock recipient in their income. The deduction must be taken for the taxable year in which the *recipient's* taxable year *ended*. (E.g., a July 31 fiscal year corporation that in May 2020 issued stock to an employee who included it in their calendar year 2020 return can claim the deduction in the corporation's fiscal year ending in *2021*.) [IRC § 83(h)]

(a) [2:173.6] **Corporation bound by amount included in recipient's income?** The IRS interprets IRC § 83 as requiring the corporate deduction to mirror the amount (and timing) of what is *actually included* in the recipient's income—even though the corporation has no control over the recipient's tax return. (However, the corporation may invoke a “safe harbor,” ¶ 2:173.7.) [Treas.Reg. § 1.83-6(a); see *Venture Funding, Ltd. v. Commr.* (1998) 110 TC 236, 240-248, aff'd without opn. (6th Cir. 1999) 198 F3d 248 (upholding IRS interpretation)]

But the Federal Circuit disagrees: The amount deductible by the corporation under IRC § 83 is the amount *includible* (i.e., *properly included by law*) in the recipient's income. Thus, the corporate deduction is not affected by the recipient's failure to report the stock (or its proper value) on their return. [*Robinson v. United States* (Fed. Cir. 2003) 335 F3d 1365, 1369-1373 (invalidating Treas.Reg. § 1.83-6(a))]

1) [2:173.7] **“Safe harbor” for corporate deduction:** To alleviate the potential problem of the “nonreporting employee,” the Regulations allow the corporation to claim the deduction in the proper year—regardless of what

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

the recipient does—so long as the corporation timely files a proper Form W-2 or 1099 with respect to the stock. [Treas.Reg. § 1.83-6(a)(2); see *Venture Funding, Ltd. v. Commr.* (1998) 110 TC 236, 245-247]

(3) [2:174] **Deferral of tax:** Another alternative is to structure the granting of stock or securities (or a partnership or LLC interest) for services so as to defer the tax thereon to a later year. The Code provides that the value of stock or securities received "in connection with the performance of services" (less any amount paid therefor, ¶ 2:177.1) must be reported as "compensation" income in the year of receipt, *unless* it is *nontransferable* or subject to a "*substantial risk of forfeiture*." In such cases, tax recognition is deferred until the recipient's rights become either transferable or no longer subject to forfeiture risk. [IRC § 83(a); see *Austin v. Commr*., TC Memo 2017-69]

• [2:174.1] **Caution re deferred compensation:** IRC § 409A applies to companies that offer their employees nonqualified deferred compensation plans—i.e., compensation earned in one year but not paid until a future year. A company will need a § 409A valuation of its common stock when granting restricted stock or stock options. Employees who receive stock or options at an incorrect price will be subject to additional taxes and fines. This is a complex provision that should be addressed with a tax specialist familiar with § 409A.

(a) [2:175] **Application—"earnout" restriction:** Tax to the recipient can be deferred if the shares are "subject to a substantial risk of forfeiture"—e.g., *conditioned* upon the recipient remaining in the employ of the corporation for a specified time (an "earnout" restriction), for failure of which the recipient forfeits the shares. In such cases, the recipient need include the fair market value of the shares in their income only in the year in which the condition of continued employment is satisfied (the "risk of forfeiture" having ended). [See Treas.Reg. § 1.83-1(a)(1), (c); *Austin v. Commr*., TC Memo 2017-69]

And, the corporation would be entitled to a corresponding *deduction* (*see ¶ 2:173.5 ff.*) in that year: i.e., the value of such shares in excess of any amount paid for them is treated as additional compensation to the recipient. [IRC § 162] (California law is in accord with the federal in allowing a deduction to the corporate employer; see Rev. & Tax.C. § 24343(a).)

1) [2:175.1] **Example:** X Corporation issues Employee 100 shares of stock, which will be forfeited if she leaves her job within 5 years. Because of the substantial risk of forfeiture, Employee will report the value of the shares as income only at the end of 5 years (i.e., when the condition lapses). At that time, the shares will be taxed according to their current fair market value (less what Employee paid) and X Corporation can claim a corresponding deduction.

(b) [2:175.2] **What constitutes receipt "in connection with performance of services":** In addition to transfers as *compensation* for services or as various other employee incentives, stock or securities may be deemed received "*in connection with* the performance of services" even though the recipient pays full market value for it. Courts have broadly construed IRC § 83 to apply to issuances of forfeitable stock as an *employment incentive* (i.e., "golden handcuffs" designed to help recruit and retain key employees) even though not received as additional compensation and even though the employee paid full value therefor. [See *Alves v. Commr.* (1982) 79 TC 864, aff'd (9th Cir. 1984) 734 F2d 478; *Montelepre Systemed, Inc. v. Commr.*, TC Memo 1991-46, aff'd (5th Cir. 1992) 956 F2d 496; compare *Centel Communications Co. v. Commr*. (7th Cir. 1990) 920 F2d 1335, 1341-1343—warrants issued to stockholder in return for guaranteeing corporate debt not received "in connection with services"]

➪ [2:175.3] ***PRACTICE POINTER:*** The amount paid by the employee for the shares is deducted from gross income in calculating taxable income. Thus, as noted below (¶ 2:176), where the employee has paid *substantial* or *full value*, the employee should elect to report the transaction in the year of receipt of the shares (when little or no tax would result), rather than risk ordinary income tax on any subsequent appreciation in value when the shares are no longer subject to forfeiture.

(c) Planning considerations

1) [2:176] **Recipient's election to treat as current income:** By making a § 83(b) election, the recipient may include the fair market value of the stock or securities in the recipient's income in the year it was first received. However, if the stock or other property is later forfeited, the recipient may *not* deduct the loss. This election must be made *within 30 days* after the recipient receives the restricted property. [IRC § 83(b); Treas.Reg. § 1.83-2; see Rev.Proc. 2012-29, 2012-28 IRB 49]

➪ [2:177] ***PRACTICE POINTER:*** Such election to report and be taxed immediately makes sense where the recipient expects the shares to increase substantially in value by the time the transfer restriction or forfeiture risk is removed: Having reported the value (less any amount paid) in the year of receipt, the recipient will be entitled to *capital gains treatment* on any subsequent increase in value when the stock is sold; whereas, if reporting is deferred, the stock will be treated as additional compensation taxable as *ordinary income* to the recipient—at its *appreciated* value—in the year the recipient's rights in the stock substantially vest (i.e., the year the transfer restrictions are removed or the forfeiture risk terminates).

The election is especially important when the recipient has paid substantial or full value for the shares: Little or no income would be recognized in the year of receipt. [See *Alves v. Commr.* (1982) 79 TC 864, aff'd (9th Cir. 1984) 734 F2d 478; Rev.Proc. 2012-29, 2012-28 IRB 49]

2) [2:177.1] **Nature of forfeiture condition:** To qualify for deferral under IRC § 83(a), the recipient's rights in the stock must be subject to a substantial risk of forfeiture—i.e., the rights must be conditioned upon the employee's performance of substantial future services or the occurrence of some other condition related to the purpose of the transaction. Transfer restrictions that, if violated, would result in forfeiture of some or all of the shares, or payment of damages or penalties (e.g., potential "disgorgement" or other penalties for insider trading (¶ 6:358 ff.)), do not constitute a substantial risk of forfeiture for IRC § 83 purposes. [See IRC § 83(a),(c)(1); Treas.Reg. § 1.83-3(c)(1); and *Austin v. Commr.*, TC Memo 2017-69]

a) [2:177.1a] **Limitation—significant shareholder:** When determining whether a substantial risk of forfeiture exists, the IRS considers the likelihood (i) the forfeiture event will occur *and* (ii) the forfeiture *will be enforced*. In the situation of a recipient who owns a significant amount of the stock of the corporation (or its parent), the recipient's position in the corporation, as well as the recipient's relationship to the officers, directors and other stockholders, must be taken into account. [See Treas.Reg. § 1.83-3(c)(1) & (3)]

Thus, a forfeiture condition will not qualify if it is unlikely to be enforced because the recipient (or their family) *controls* the corporation or is a *key person* in a corporation with *only a few shareholders*. [See *QinetiQ U.S. Holdings, Inc. & Subsidiaries v. Commr.*, TC Memo 2015-123, aff'd (4th Cir. 2017) 845 F3d 555, 564—no substantial risk of forfeiture of stock held by key person who was one of two nearly equal shareholders; compare *Austin v. Commr.*, TC Memo 2017-69—shares held by 2 shareholders who each had 47.5% of corporation's stock (with ESOP having remaining 5%) were subject to substantial risk of forfeiture where each shareholder "had a strong incentive" to enforce 5-year earnout restriction against other shareholder]

b) [2:177.2] **Relationship of forfeiture to share price:** The forfeiture risk must involve surrender of the stock for *less* than its fair value. Requiring resale at the same price as paid, or at book value, would not constitute a forfeiture if such price equaled the stock's fair value at the time of repurchase. [See Treas.Reg. § 1.83-3(c)(1) & (4), Ex. (1), (4)]

3) [2:177.3] **Gradual vesting of ownership:** If the recipient does not expect to have sufficient cash to pay income tax on all of the stock at one time (i.e., in the year the forfeiture condition ends), the transaction may be structured so that the forfeiture condition lapses only as to a specified percentage of the shares for each year of employment or other required performance.

a) [2:177.4] **Example:** One-third of a recipient-employee's shares could be made subject to repurchase by the corporation (at less than fair value) if the employee leaves the company within four years, another third if the employee leaves within five years, and the remainder if the employee leaves within six years.

4) [2:177.4a] **Election to further defer recognition:** The recipient may elect to defer recognition of the amount of income from exercising a restricted stock unit (RSU) or qualified stock option for up to five years from the vesting date of an "eligible corporation" (¶ 2:177.4c). The election must be made no later than *30 days* after the stock or securities become transferable or the recipient's right to the stock or securities is substantially vested, whichever occurs first. [IRC § 83(i)(1), (4)(A); see IRS Notice 2018-97]

a) [2:177.4b] **Potential 5-year deferral:** Recognition of gain may be deferred to the taxable year in which the *earliest* of the following events occurs:

• The stock becomes *transferable* (including transferable to the employer);

• The recipient-employee becomes an "excluded employee" (generally, a *1% shareholder*, the *chief executive or financial officer*, or one of the *four highest compensated* corporate officers);

• *Any* stock of the corporation becomes readily tradable on an established securities market;

• *Five years* after the stock or securities become transferable or not subject to a substantial risk of forfeiture, whichever occurs first; or

• The recipient *revokes* the election. [IRC § 83(i)(1)(B), 3(B)]

b) [2:177.4c] **"Eligible corporation":** Generally, an eligible corporation is one that:

• Does not have any stock readily tradable on an established securities market; and

• Has a written plan granting stock options to at least 80% of its employees who provide services in the United States. [IRC § 83(i)(2)(C)]

e. Compare—other taxes

(1) [2:177.5] **State sales tax:** Regardless of whether a partnership, LLC or corporation is formed, the transfer of "tangible personal property" (i.e., investor's business assets) in exchange for stock or other consideration may result in state sales tax liability. Thus, each *noncash* transfer needs to be reviewed to determine whether it is subject to the state sales tax law. [See Rev. & Tax.C. § 6001 et seq.]

(a) [2:177.5a] **Contributions to commencing corporations:** A transfer of property to a *commencing corporation* (or partnership) *solely in exchange for "first issue stock"* (or a partnership interest) is *exempt* from sales tax. But the exemption does *not* apply where the investor receives other consideration such as cash or notes. Nor does the exemption apply where the corporation assumes any of the investor's debt—whether or not the investor remains liable on the debt. [18 CCR § 1595(b)(4); *Beatrice Co. v. State Bd. of Equalization* (1993) 6 C4th 767, 782-783, 25 CR2d 438, 448—wholly-owned subsidiary's assumption of corporate parent's debts rendered transfer taxable despite parent's continued liability; see *Industrial Asphalt, Inc. v. State Bd. of Equalization* (1992) 5 CA4th 1237, 1240, 7 CR2d 444, 445—taxable transfer under § 1595 resulted at formation of joint venture that assumed primary responsibility for investor's debt]

(2) [2:177.6] **Real property taxes:** A transfer of real property in connection with the formation of a corporation, partnership or LLC may constitute a "change in ownership," triggering a reassessment of property value under Cal. Const. Art. XIIIA (commonly known as "Proposition 13"). [Rev. & Tax.C. §§ 60, 61(j)]

(a) [2:177.7] **Structuring initial transfer to avoid reassessment:** Such a transfer will be insulated from "change in ownership" reassessment *only* if (i) the transfer results solely in a change in the method of holding title to the property, *and* (ii) the proportional ownership interests of the shareholders, partners or LLC members *immediately after* the transfer are the same as their ownership interests in the property prior to the transfer. [Cal. Const. Art. XIIIA, § 2(a); Rev. & Tax.C. §§ 62(a)(2), 64(d); see *926 North Ardmore Ave., LLC v. County of Los Angeles* (2017) 3 C5th 319, 326-327, 219 CR3d 695, 700 & fn. 6; *Fashion Valley Mall, LLC v. County of San Diego* (2009) 176 CA4th 871, 874, 98 CR3d 327, 329—transfer of shopping mall to LLC in return for 50% ownership interest in LLC's parent (another LLC) triggered reassessment of entire mall (rejecting argument that only 50% interest in mall should be reassessed)]

• [2:177.7a] **Example:** A transfer of real property from two individuals, as equal cotenants, to a corporation in which each of the individuals takes back 50% of the stock, does *not* result in a change of ownership. [18 CCR § 462.180(b)(2); see *Zapara v. County of Orange* (1994) 26 CA4th 464, 470, 31 CR2d 555, 558, fn. 5]

[2:177.7b - 2:177.7e] ***Reserved.***

1) [2:177.7f] **Similar rule re documentary transfer tax:** Likewise, the documentary transfer tax imposed by California counties (Rev. & Tax.C. § 11901 et seq.) does not apply to a transfer of property upon formation of a corporation, partnership or LLC where (i) the transfer results solely in a change in the method of holding title to the property and (ii) the proportional ownership interests of the shareholders, partners or LLC members remain the same

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

immediately after the transfer. [Rev. & Tax.C. § 11925(d); see *926 North Ardmore Ave., LLC v. County of Los Angeles* (2017) 3 C5th 319, 337, 219 CR3d 695, 708 & fn. 18]

(b) [2:177.8] **Reassessment upon subsequent transfer of stock, LLC interests or partnership interests:** Although initial formation of the corporation, partnership or LLC may have been structured to avoid reassessment (¶ 2:177.7), a "change in ownership" will nevertheless result upon *subsequent* transfers of shares, partnership or LLC interests representing cumulatively more than half of the total stock or interests. Additionally, a "change in ownership" of the underlying real property occurs whenever there is a shift in ownership or control of a majority of the stock, partnership interests or LLC interests even though less than a majority has been transferred (e.g., a 49% owner acquires an additional 2% ownership interest). [Rev. & Tax.C. § 64(c), (d); 18 CCR § 462.180(d); see *926 North Ardmore Ave., LLC v. County of Los Angeles* (2017) 3 C5th 319, 326-327, 219 CR3d 695, 700 & fn. 5; *North Valley Mall, LLC v. Longs Drug Stores Calif., LLC* (2018) 27 CA5th 598, 605, 238 CR3d 368, 373]

Thus, for example:

• [2:177.8a] Purchase of a 50% partnership interest followed by a preplanned partnership dissolution and transfer of the underlying realty to the purchaser constituted a "change in ownership" under the "step transaction" doctrine. [*Shuwa Investments Corp. v. County of Los Angeles* (1991) 1 CA4th 1635, 1651-1653, 2 CR2d 783, 792-793]

• [2:177.8b] A transfer of title by parent and subsidiary to a general partnership consisting of subsidiary and third party corporation constituted a "change in ownership" under the "step transaction" doctrine. [*McMillin-BCED/Miramar Ranch North v. County of San Diego* (1995) 31 CA4th 545, 558-561, 37 CR2d 472, 479-481]

• [2:177.8c] A partner's buy-out of the remaining partners' interests constituted a "de facto" dissolution and hence a "change in ownership." [*Zapara v. County of Orange* (1994) 26 CA4th 464, 469, 31 CR2d 555, 558]

1) [2:177.9] **Filing "change in ownership statement" required:** Within 90 days of a change in ownership or control of a corporation, partnership, LLC or other legal entity owning real property in California, a "change in ownership statement" (Form BOE-100-B) must be filed with the Sacramento office of the State Board of Equalization. The statement must be filed by the entity (in the case of a change in ownership) or the person acquiring control (in the case of a change in control). [Rev. & Tax.C. §§ 480.1(a)-(c), 480.2(a)-(c)]

2) [2:177.10] **Documentary transfer tax:** Similarly, a documentary transfer tax (¶ 2:177.7f) may be imposed whenever a transfer of an interest in a corporation, partnership or LLC results in a "change in ownership" of the underlying property within the meaning of Rev. & Tax.C. § 64(c) or (d) (¶ 2:177.8) so long as there is a written instrument conveying a majority interest in the legal entity that owns, directly or indirectly, the real property. This is so even where the instrument does not directly reference the real property and is not recorded. [Rev. & Tax.C. § 11911; *926 North Ardmore Ave., LLC v. County of Los Angeles* (2017) 3 C5th 319, 329-338, 219 CR3d 695, 702-709; *see ¶ 8:118.20a*]

➪ [2:177.11] ***PRACTICE POINTER:*** Few incorporations (or partnership or LLC formations) involving real estate will be simple enough to avoid triggering Prop. 13 reassessment (and documentary transfer taxes). Indeed, considerations other than property taxes are usually more important in structuring the transaction. Nevertheless, lawyers should always advise their clients of the possibility of a reassessment (rather than be accused of having overlooked the issue).

Cross-refer: For a more detailed treatment of the property tax "change in ownership" rules, see Greenwald & Bank, *Cal. Prac. Guide: Real Property Transactions* (TRG), Ch. 13.

3. [2:178] **Taxation on Disposing of Investment:** As previously discussed, operating profits or losses are taxed directly to the corporation and not to its shareholders. By contrast, the owners of a sole proprietorship, partnership, LLC or S corporation are individually taxed on the operating income of the business.

Different tax consequences also are encountered when the owners of a business dispose of their interests: A sole proprietor is the direct owner of all assets of the proprietor's business and recognizes taxable gain or loss directly on sale thereof. But the owners of a corporation, partnership or LLC business generally can sell their ownership interests separate and apart from the business assets. The sale of such interests is taxable as a capital transaction (capital gain or loss), except for IRC § 1244 stock discussed below (*¶ 2:188 ff.)*.

Cross-refer: The paragraphs below (¶ 2:179 ff.) contain a simplified discussion with regard to partnerships and LLCs. In some situations, such as those involving unrealized receivables and "substantially appreciated inventory," the tax aspects can

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

be more complicated, to both the individual and the entity. For a more detailed discussion of the tax aspects of disposition of partnership and LLC interests, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 8.

a. [2:179] **Capital gains:** On sale or other taxable disposition of a capital or investment asset held more than 12 months, capital gain is recognized to the extent of the amount realized less the seller's basis. For *individuals*, capital gains are subject to a maximum tax rate of 20%. This rate is considerably lower than the top marginal rate of 37% on ordinary income (*see ¶ 2:99*). [See IRC § 1(h)]

For *corporations*, the maximum capital gain rate is 21% (i.e., the maximum rate on *all* corporate income; *see ¶ 2:102*). [IRC §§ 11, 1201(a)]

(1) [2:179.1] **Importance of distinction between capital gains and ordinary income:** Apart from the difference in tax rates, the distinction between capital gains and ordinary income remains important:

- First, in a capital gain transaction, the taxpayer *subtracts* their *basis* in determining taxable gain (or loss). In the case of ordinary income, there is no “basis” to subtract. [IRC § 1211(b)]

- Second, taxable *capital gains* are reduced by *all capital losses*—including those that are unrelated to disposition of the business interest—so that only the *net* capital gain is included in income. In contrast, *ordinary* income may *not* be reduced by *capital losses* (except up to $3,000 annually for individuals). [IRC § 1211(b)]

(2) [2:180] **Tax planning:** Under the current rate structure, a reason for incorporating may be to “shelter” profits that are to be retained undistributed under the lower 21% corporate rate.

[2:181] As these profits are retained, the value of the business increases, and so does the value of the corporation's stock. But no tax is paid on this increased value until the shares are sold (subject to the limitations on unreasonable accumulations of earnings (*¶ 2:113*) and personal holding company income (*¶ 2:110*)).

[2:182] No such alternative exists for proprietorships, partnerships, LLCs or S corporations, because the profits—whether or not distributed—are “passed through” each year to the individual owners.

[2:182.1] In contrast, there are only a few discernible tax advantages to operating under the corporate form. These include the facts that:

- It is easier for corporations to sustain a “trade or business” classification for various activities;

- The “passive activity” loss limitations apply only to certain closely-held corporations and “personal service corporations” (*¶ 2:118.3 ff.*); and

- Where the passive loss rules do apply, it is easier for corporations to establish “material participation” (*¶ 2:118.10, 2:118.16*).

b. Losses

(1) [2:183] **Business losses:** Since the corporation is a separate tax-paying entity, its losses cannot be claimed by its shareholders to offset their other income, as in the case of a partnership, LLC or proprietorship (¶ *2:87, 2:90*). Special rules enable an *S corporation* to “pass through” its losses to its shareholders (*see ¶ 2:122*).

Note, however, that an ordinary corporation's net operating losses (NOLs) may be carried forward indefinitely to reduce up to 80% of corporate taxable income in future tax years. [IRC § 172]

(2) [2:184] **Losses on investment:** If the business proves unsuccessful, and the investors sell their interests at a loss (or the interests become worthless), those losses will be deductible either as an “*ordinary loss*” or as a “*capital loss*”—depending on the form of the business entity, as stated below (¶ 2:185 ff.). (An ordinary loss is far more advantageous for tax purposes, since it can be used in full to offset taxable income. A capital loss can be used to offset capital gains, but otherwise only up to $3,000 per year can be written off against taxable income.) [See IRC §§ 165(g), 1211]

(a) [2:185] **Proprietorship:** Losses on investment in a sole proprietorship business usually result in *ordinary loss*. This is because it is the business assets which are being sold and, under IRC § 1231, assets held for use in a trade or business (such as machinery, equipment, even real property) are given special tax treatment: Net *gains* on sale thereof are taxed

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

as capital gains; but net *losses* are deductible in full as *ordinary* losses (subject to "passive activity" loss limitations; *¶ 2:87.1 ff.*). [IRC § 1231(a)]

(b) [2:186] **Partnerships and LLCs:** An interest in a partnership or LLC is a capital asset; thus, partners or members who sell their interests at a loss recognize a *capital loss* (with the limited tax benefits noted above, ¶ 2:184).

Therefore, where the business proves unsuccessful, it is not advantageous for the partners or members to sell their interests directly to a purchaser. Rather, it is generally preferable for the *entity* to sell the business assets pursuant to IRC § 1231 (¶ 2:185) and "pass through" the resulting ordinary loss to the owners. The owners can then use the ordinary loss to offset their other income (subject to the "at risk," "passive activity," etc. limitations on deductibility previously discussed; *see ¶ 2:91 ff.*).

(c) [2:187] **Corporations:** Corporate shares are normally treated as capital assets, and therefore losses on sale or exchange thereof would ordinarily be deductible only as a *capital loss.* ("Worthless" shares are treated as "sold" on the last day of the year in which they become "worthless.") [IRC § 165(g); see *Delk v. Commr.* (9th Cir. 1997) 113 F3d 984, 986]

1) [2:188] **Ordinary loss on § 1244 stock:** However, to encourage investment in small business corporations, the Code contains a special relief provision: IRC § 1244 allows the original purchasers of stock of a "small business corporation" (including S corporations) to write off losses on sale or exchange of their stock against their other income (i.e., as ordinary losses, rather than capital losses)—up to *$50,000* per year, or $100,000 per year for married taxpayers filing jointly. Losses in excess of these amounts are deductible only as capital losses. [IRC § 1244]

• [2:188.1] **Not subject to "passive activity" rules:** Losses incurred upon the sale or exchange (or worthlessness) of IRC § 1244 stock do *not* appear to be subject to the rules limiting the deductibility of passive activity losses (*¶ 2:87.1 ff.*). Reason: The purchase of § 1244 stock ordinarily would not "involve the conduct of any trade of business," which is required under the rules. [See IRC § 469(c)(1)(A)] Moreover, even if holding § 1244 stock were to constitute a "passive activity," the limitations on deductibility would *cease to apply* upon the sale or other disposition (e.g., worthlessness) of the holder's entire interest. [IRC § 469(g); *¶ 2:87.11*]

This is an important advantage of the corporate form where the amount invested is substantial. The following requirements must be met:

a) [2:189] **"Small business corporation":** At the time the stock was issued, the total amount received for all stock in the corporation must not exceed $1,000,000. Also, for its last five tax years preceding the loss (or throughout its existence if less than five years), the corporation must have been actively engaged in business operations (as opposed to deriving most of its income from "portfolio income"—e.g., rents, royalties, dividends, etc.). [IRC § 1244(c); see *Crigler v. Commr.*, TC Memo 2003-93; *Schwartz v. Commr.*, TC Memo 1995-415]

b) [2:190] **Any class of stock:** Any class of shares will qualify for IRC § 1244 treatment. The purpose is to encourage unrestricted investments in the capitalization of "small business corporations." [IRC § 1244(c)]

c) [2:191] **Issued for cash or property:** Ordinary loss treatment is limited to shares issued for cash or property (other than stock or securities). Shares issued for *services* cannot qualify as IRC § 1244 stock. [IRC § 1244(c); see *Schwartz v. Commr.*, TC Memo 1995-415—shareholder's pledge of personal assets to secure loan to corporation did not increase § 1244 stock basis]

1/ [2:191.1] **Caution re additional capital contributions:** Additional contributions of cash or property do *not* increase the deductible basis of previously issued IRC § 1244 stock. To make the contributions deductible under § 1244, *additional stock* must be *issued*. [*Bledsoe v. Commr.*, TC Memo 1995-521; see *Schwartz v. Commr.*, TC Memo 1995-415]

d) [2:192] **Initial purchasers:** Only the initial investor can claim IRC § 1244 treatment; subsequent purchasers cannot. The investor must be an individual or partnership; corporate purchasers do not qualify. [IRC § 1244(a)]

e) [2:193] **Written plan not required:** The former requirement that IRC § 1244 stock be issued pursuant to a formally-adopted "plan" has been deleted.

➪ [2:194] ***PRACTICE POINTER:*** However, it is still good practice for the board of directors to adopt a resolution at the time the stock is issued designating the stock as IRC § 1244 stock, so as to call the potential deduction to the attention of the issuees (*see ¶ 4:468*).

[2:195] ***Reserved.***

4. [2:196] **Deductibility of Organizational Expenses:** Expenses of organizing a corporation (or other entity) may be substantial. Such expenses are of a capital nature and therefore ordinarily are *not* deductible in the year in which expended (rather, they are to be taken into account when determining gain or loss on sale or liquidation of the enterprise).

However, a new corporation (or other entity) can elect to deduct *up to $5,000* of organizational expenses in the tax year in which it begins business. The $5,000 maximum is reduced by the amount by which the organizational expenses exceed $50,000. Any remaining organizational expenses can be deducted ratably over a 180-month period. [IRC §§ 248 (corporations), 709 (partnerships)]

a. [2:196.1] **Organizational expenses for corporations:** Organizational expenses that qualify for deduction/amortization under IRC § 248 are those that are *directly incident* to creation of the corporation. Such expenses include:

- *Legal* expenses incident to organization, such as drafting the articles, bylaws, minutes of organizational meetings and terms of original stock certificates;
- Necessary *accounting* services;
- Expenses of *temporary* directors and of directors' or shareholders' *organizational meetings*; and
- *Fees paid to the Secretary of State* for filing the articles of incorporation. [Treas.Reg. § 1.248-1(b)(1), (2)]

In contrast, expenditures connected with *issuing or selling stock or other securities* (such as commissions, professional fees, and printing costs) and expenditures connected with the *transfer of assets* to the corporation do *not* qualify for deduction/amortization under § 248. [Treas.Reg. § 1.248-1(b)(3)]

b. [2:196.2] **No amortization until business begins:** The amortization allowed under IRC § 248 is spread over a period beginning with the *month* in which the corporation "*begins business*." Although a corporation comes into existence upon incorporation, it does not "begin business" until it *starts business operations*. This may occur when its activities "have advanced to the extent necessary to establish the nature of its business operations" (e.g., acquisition of necessary operating assets). [Treas.Reg. § 1.248-1(d) (emphasis added)]

5. [2:197] **Fringe Benefits:** A major advantage of doing business as a corporation, as opposed to a partnership, LLC or sole proprietorship, is more favorable tax treatment for a broader range and extent of fringe benefits.

➪ [2:198] ***CAUTION—S CORPORATIONS*:** Restrictions apply to fringe benefits received by S corporation shareholders. *See ¶ 2:131*.

[2:199 - 2:214] ***Reserved.***

a. [2:215] **Group term life insurance:** A corporation may deduct (as a business expense) premiums paid for group life insurance provided to its employees. The insurance provided is *not taxable* income to the employees if furnished by the employer on a nondiscriminatory basis, and coverage is limited to $50,000 (if more, the employees are taxed on premiums attributable to the excess, but at extremely favorable rates). [IRC § 79]

b. [2:216] **Health insurance; medical expense reimbursement plans:** Premiums for employee accident, health and disability plans are deductible both by corporate and noncorporate businesses. If furnished on a nondiscriminatory basis, neither the coverage nor the benefits received are taxable to the employees. [IRC §§ 105(e), 162(*l*)(1)(B); see IRC § 106; and *DKD Enterprises v. Commr.* (8th Cir. 2012) 685 F3d 730, 738—deductions for premiums paid by corporation for sole shareholder's/employee's medical insurance disallowed because not made according to actual, predetermined plan]

However, a corporation has the added advantage of being able to deduct payments to its employees to reimburse them for medical expenses (usually for amounts not covered by insurance). Here again, employees are not taxable on the amount received as long as reimbursement is provided by the employer on a nondiscriminatory basis. [IRC § 105(h)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[2:217 - 2:218] ***Reserved.***

c. [2:219] **Employee "incentive stock options":** Normally, stock options granted to employees in connection with their employment are treated as additional compensation to the employee. There is no tax consequence when the option is granted, but when it is *exercised*, the difference between the exercise price and the fair market value of the shares purchased is taxed as *ordinary income* (*see ¶ 6:406.1*). [See, e.g., *Cramer v. Commr.* (9th Cir. 1995) 64 F3d 1406, 1410-1414; *Falkowski v. Imation Corp.* (2005) 132 CA4th 499, 515, 33 CR3d 724, 736, fn. 16]

[2:220] The Code gives more liberal tax treatment to employee "incentive stock options." If the requirements below (¶ 2:221 ff.) are met, there is no tax consequence to the employee at the time the stock option is *granted or* when it is *exercised*. Instead, tax is deferred until the shares are *sold* (which could be years later), at which time the gain is taxable as a capital gain at a maximum *20%* rate (as opposed to the *37%* maximum ordinary income rate). [IRC §§ 421(a), 422; see Treas.Reg. § 1.421-2(a)(1); and *Falkowski v. Imation Corp.* (2005) 132 CA4th 499, 515, 33 CR3d 724, 736, fn. 16]

[2:220.1] However, the following factors limit the attractiveness of incentive stock options:

• The difference between the option and market prices at the time of exercise is an item of tax preference (see IRC § 57(a)(3)); and

• The granting corporation receives no deduction for providing such additional compensation to the employee. [IRC § 421(a); see Treas.Reg. § 1.421-2(a)(1)]

Indeed, incentive stock options may end up costing both the employee and the corporation more in taxes.

Here are the requirements:

(1) [2:221] **Employee requirements:** The employee receiving the stock option must:

• Be *continuously employed* by the corporation (or a "related" corporation, such as a 50%-or-more subsidiary) from the time the option was granted until at least three months before it was exercised (12 months for disabled employees); and

• *Hold* the stock until at least two years after the option was granted and one year after it was exercised. [IRC § 422(a); Treas.Reg. §§ 1.421-1(h)(2) & (3), 1.422-1(a)(1)(i), 1.424-1(f); see *Falkowski v. Imation Corp.* (2005) 132 CA4th 499, 512-513, 33 CR3d 724, 734-735]

(a) [2:221.1] **Leave of absence allowed:** The above three-month employment period is treated as continuing intact while the employee is on military leave, sick leave or other bona fide leave of absence of up to *three months*, but an even longer leave is allowable if a statute or contract assures reemployment. [Treas.Reg. § 1.421-1(h)(2)]

(b) [2:221.2] **Permitted transfers during holding period:** The two-year/one-year holding period (*¶ 2:221*) is not violated by a stock transfer made by reason of the shareholder's *death, divorce or bankruptcy*, or a *nontaxable corporate reorganization* (merger, spin-off, etc.; *see ¶ 8:118.18*). [Treas.Reg. §§ 1.422-1(a)(2), 1.424-1(c)]

The holding period likewise is not violated by a mere *pledge* or *hypothecation* of the stock, but a *resulting disposition* would run afoul of the holding period. Similarly, a transfer into *joint ownership* does not violate the holding period, but a *subsequent* transfer, other than by death or back to the employee, would violate the holding period. [Treas.Reg. § 1.424-1(c)]

(c) [2:222] **Consequences of noncompliance:** Failure to meet the employee requirements (*¶ 2:221*) results in *ordinary income to the employee* under the rules for nonqualified stock options (*¶ 2:219*). However, in such cases the granting corporation receives a *deduction* in the amount of the employee's taxable *gain*. [IRC § 422(c)(2); Treas.Reg. § 1.421-2(b)]

(2) [2:223] **Corporate employer requirements:** The incentive stock option must be granted under a formal plan approved by the shareholders within 12 months before or after it was adopted by the board of directors. The plan must specify the maximum aggregate number of shares that may be issued through incentive stock options, as well as the employees or classes of employees eligible to receive the shares. In addition:

• The options granted under the plan must be:

— Granted within 10 years after the board's adoption of the plan (or shareholder approval, or earlier);

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

— Exercisable only by the employee to whom granted;

— Exercisable within 10 years after it was granted (5 years for options granted to employees already owning more than 10% of the corporation's stock);

— Exercisable at a price which is at least equal to the fair market value of the stock on the date the option was granted (110% of the market value in case of options granted to employees already owning more than 10% of the stock);

— Nontransferable except upon death; *and*

• No more than $100,000 market value of stock (at time of grant) may become exercisable for the first time in any calendar year. [IRC § 422(b),(c),(d); see Treas.Reg. §§ 1.421-1(b)(2), 1.422-2, 1.422-3, 1.422-4, 1.424-1(d)]

[2:223a - 2:223d] ***Reserved.***

(a) [2:223e] **Change to option deemed new option:** An extension or renewal of the terms of an option, or a modification that gives the employee *additional benefits* under the option, is treated as the grant of a *new* option (which may or may not qualify as an incentive stock option). For example, a modification that reduces the exercise price is deemed the grant of a new option on the date of the modification. [Treas.Reg. § 1.424-1(e)]

1) [2:223f] **Offer to modify option:** An offer to modify the option in such a way as to give the employee additional benefits under the option is *not* treated as a new option *unless:*

— the offer remains *outstanding for 30 days or more* (in which event a new option is deemed granted as of the date of the offer), or

— the modification is actually *made*. [Treas.Reg. § 1.424-1(e)(4)(iii)]

2) [2:223g] **Certain corporate transactions excepted:** A change in an option or issuance of a new option to reflect a stock dividend or split, or caused by a corporate reorganization (e.g., merger, liquidation, or acquisition of property or stock), is *not* treated as the grant of a new option if certain conditions are met (essentially, the terms of the "new" option must be the same except for changes made necessary by the corporate transaction). [Treas.Reg. § 1.424-1(a),(e); see *Falkowski v. Imation Corp.* (2005) 132 CA4th 499, 512-513, 33 CR3d 724, 734-735 & fn. 14]

(3) [2:223.1] **Employee stock purchase plans:** Employees may also be granted rights to purchase the corporation's stock at a "discount," with recognition of any gain *deferred* until resale of the shares. [IRC § 423; Treas.Reg. §§ 1.423-1, 1.423-2]

[2:223.2] To receive such favorable tax treatment, an employee stock purchase plan satisfying the requirements of IRC § 423 must be approved by the shareholders within 12 months before or after the plan is adopted. Among other things, the plan must include the following provisions:

• Nondiscriminatory participation must be available to substantially all full-time employees (except certain highly compensated employees, whose inclusion is optional);

• The maximum fair market value of stock which an employee can be granted the right to purchase under the plan in any year may not exceed $25,000;

• The purchase price of the stock must be at least 85% of the market price on either the grant date, or the purchase date, whichever is lower;

• The purchase rights must be exercised within specified time periods, and must be nontransferable (except at death);

• Shares sold within one year of purchase, or two years of grant, are "disqualified" from receiving favorable tax treatment and are taxed on resale as if they had been acquired on exercise of any other nonqualified stock option (¶ *2:222*). [See IRC § 423]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[2:224 - 2:227] ***Reserved.***

d. [2:228] **Retirement benefits—favorable tax treatment not limited to corporate entities:** Tax-qualified retirement plans are authorized under the IRC for both corporate *and noncorporate* businesses, and are treated substantially the same for tax purposes. (However, corporate plans have the significant advantage of permitting loans to plan participants.)

(1) [2:228.1] **Advantages of "tax-qualified" plan:** A "tax-qualified" retirement plan is one under which the business gets a current deduction for contributions made to the plan, yet no income is taxable currently to the persons on whose behalf the contributions were made. Earnings on the amounts contributed accumulate tax-free. Taxation is *deferred* until the beneficiary receives payments under the plan at retirement, or the plan is otherwise terminated. [IRC § 401; see *DKD Enterprises v. Commr.* (8th Cir. 2012) 685 F3d 730, 737]

(a) [2:228.2] **Plan must be for *employees:*** Contributions to a plan are deductible so long as the plan is "of an employer for the exclusive benefit of his employees or their beneficiaries." [IRC § 401(a)]

1) [2:228.2a] **Keogh plans for self-employed individuals:** A partner or sole proprietor is considered both an employer and an employee, and thus may deduct contributions to a tax-qualified "Keogh" plan. [IRC § 401(c)(1) & (4)]

2) [2:228.2b] **Compare—S corporation shareholders:** An S corporation, like a C corporation, may establish a qualified retirement plan for its employees, including employee shareholders. However, S corporation shareholders are *not* considered "self-employed" under the Code provisions governing retirement plans, and thus may *not* deduct pass-through income contributed to a shareholder's Keogh plan. [*Durando v. United States* (9th Cir. 1995) 70 F3d 548, 551-553]

(2) 2023 maximum annual deductions

• [2:228.3] For *defined contribution* plans (e.g., employee profit-sharing), the deductibility limit is *$69,000.* [IRS Notice 2023-75, 2023-47 IRB 1256]

• [2:228.3a] For *defined benefit* plans, the limit is the amount necessary to fund a lifetime pension commencing at normal retirement age (as under Social Security rules) paying average earnings during the beneficiary's three highest consecutive years (not taking into account annual compensation exceeding $250,000), up to a maximum limit of *$275,000* (subject to inflation adjustments, ¶ 2:228.4). The $275,000 limit may be actuarially increased for retirement after "normal" retirement age; and must be actuarially decreased for retirement *before* the "normal" retirement age. [IRC §§ 401(a)(17), 415(b)(2)(C), (D),(c)(1); see IRS Notice 2023-75, 2023-47 IRB 1256]

(a) [2:228.4] **Inflation adjustment:** Both the $69,000 defined contribution limit and the $275,000 defined benefit limit are subject to cost-of-living increases based on the rate of Social Security benefit increases. [IRC § 415(d); see IRS Notice 2023-75, 2023-47 IRB 1256]

(3) [2:228.5] **Discriminatory plans prohibited:** A tax-qualified retirement plan may not discriminate (i.e., pay disproportionately higher benefits) in favor of "key employees." A "key employee" is (a) an officer receiving compensation greater than $220,000, (b) a more-than-5% owner, or (c) a more-than-1% owner receiving compensation greater than $150,000. [IRC § 416(a),(c),(g),(i); see IRS Notice 2023-75, 2023-47 IRB 1256]

e. [2:229] **Caution—§ 269A trap for "personal service corporations":** Professionals and others in business frequently desire to incorporate solely to obtain tax benefits. However, the IRS has the power to disallow deductions and to reallocate income between a "personal service corporation" and its owner-employees so as to eliminate the corporate tax advantage.

(1) [2:230] **"Personal service corporation" defined:** A "personal service corporation" is one: (a) whose principal activity is to provide the personal services of its owner-employees (persons individually owning more than 10% of stock on any day of the year) to *another* corporation, partnership or business entity; *and* (b) *formed primarily for tax avoidance* by securing tax benefits for the owner-employees that would otherwise not be available (e.g., retirement plans or other fringe benefits). [IRC § 269A]

• [2:230.1] **Compare:** Under the "passive activity" loss limitations, a personal service corporation is *not* limited to a single client, and includes businesses whose services are rendered by employee-owners who collectively (though not individually) own more than 10% (in value) of the stock. [IRC § 469(h)(2); ¶ *2:118.14*]

(a) [2:231] **Application:** This would apply, for example, to athletes, performers or professionals who incorporate for tax reasons, and then have their corporation contract to provide their services to a single employer. Or, where one member

of a partnership incorporates and his corporation thereafter provides his services to the partnership. But it would *not* apply to the typical professional corporation (doctors, lawyers, etc.) which performs services for a *variety* of clients. [IRC § 269A]

Cross-refer: For additional discussion of the differences between corporate and pass-through taxation, including a chart comparing in dollar amounts the taxation of a hypothetical business operated as a pass-through entity with the taxation of the same business operated as a corporate entity, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 2.

[2:232 - 2:233] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 2-D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 2. Substantive Law Considerations in Choosing Business Entity: Tax and Nontax Factors

---

D. Estate Planning Considerations

1. [2:234] Tax Consequences
a. [2:234.1] Federal estate tax exclusion
(1) [2:234.2] Federal estate tax exclusion for married couples
b. [2:234.6] 40% rate on largest taxable estates
c. [2:235] General estate tax considerations for larger businesses
(1) [2:235.1] Sole proprietorship
(2) [2:236] Partnership and LLC
(3) [2:237] Corporation
(a) [2:238] Facilitating transfer
(b) [2:239] Paying death taxes through stock redemption
(c) [2:240] Freezing values for estate tax purposes
1) [2:240a] Example
2) [2:240.1] Caution—complex tax valuation rules
2. [2:240.2] Probate Proceedings (Ancillary Administration)
SUMMARY ADVANTAGES VS. DISADVANTAGES OF INCORPORATION

1. [2:234] **Tax Consequences:** As discussed below (¶ 2:234.1 ff.), small business owners whose total estates fall within the estate tax exemption can pass their businesses to their families at death without tax consequences—*regardless of the form of business entity*.

Of course, many small businesses will grow into large ones. Thus, practitioners should always consider potential estate taxes when choosing the form of entity.

Cross-refer: Significant estate tax considerations are over-viewed in the sections below (¶ 2:234.1 ff.). For a comprehensive treatment of the federal estate tax, see Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 10.

a. [2:234.1] **Federal estate tax exclusion:** For persons dying in 2022, the first $12,060,000 in estate value is excluded from federal estate tax. (For persons dying after 2022, the $12,060,000 exclusion is increased annually, rounded to the nearest multiple of $10,000, to account for inflation.) [IRC § 2010(c)(1)-(3); see Rev.Proc. 2021-45, IR-2021-219]

(1) [2:234.2] **Federal estate tax exclusion for married couples:** Generally, the value of an estate for federal estate tax purposes is reduced by the amount passing to a surviving spouse (the "marital deduction"). [IRC § 2056(a); see *Donkin v. Donkin* (2013) 58 C4th 412, 416, 165 CR3d 476, 479]

If the estate of the first spouse to die does not use the entire $11,700,000 exclusion (as adjusted for inflation, ¶ 2:234.1), the deceased spouse's executor may elect to apply the unused portion to the estate of the surviving spouse, to be used upon that spouse's death. [IRC § 2010(c)(4), (5)]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Thus, with the combination of the marital deduction and the deceased spouse's unused exclusion, a married couple's estate of up to $23,400,000 (as adjusted for inflation) can be excluded from federal estate tax.

[2:234.3 - 2:234.5] ***Reserved.***

b. [2:234.6] **40% rate on largest taxable estates:** For federal estate tax purposes, taxable estates are subject to graduated rates beginning at 18%. Larger estates are subject to the following marginal rates:

Taxable Estate	Rate
$250,001 to $500,000	34%
$500,001 to $750,000	37%
$750,001 to $1,000,000	39%
Over $1,000,000	40%

(These brackets are *not* subject to increase for inflation.) [IRC § 2001(c)]

c. [2:235] **General estate tax considerations for larger businesses:** For a business large enough to have possible estate tax consequences (including a small business with growth potential), a corporation may have advantages over a noncorporate entity.

(1) [2:235.1] **Sole proprietorship:** Ordinarily, upon a sole proprietor's death, business assets are treated as any other property: i.e., they may have to be probated, and will be subject to federal estate tax at their full value at death (thus reaching even items such as uncollected receivables, goodwill, etc.).

(2) [2:236] **Partnership and LLC:** The value of a deceased partner's or LLC member's interest is includible in their gross estate for estate tax purposes. This necessarily includes the value of their share of all business assets.

However, an adjustment (discount) may be appropriate for a partnership or LLC interest that is *not readily marketable* or is *not* a *controlling interest* (i.e., the interest cannot control the business or its dissolution). Indeed, *limited* partnership and minority *nonmanaging* LLC interests may be eligible for significant valuation discounts, which can provide important estate planning opportunities.

(3) [2:237] **Corporation:** Similarly, upon a shareholder's death, the value of the shareholder's shares is includible in the estate. Here too, because of the greater flexibility in establishing various kinds of ownership interests, there are important estate planning opportunities.

(a) [2:238] **Facilitating transfer:** Shares may be transferred and divided among several beneficiaries either through inter vivos gifts or upon death (testamentary disposition or intestate succession). This may be an important advantage over a proprietorship or partnership.

(b) [2:239] **Paying death taxes through stock redemption:** Another estate planning feature of the corporate form is that earnings can be distributed to a shareholder to redeem shares to provide funds to pay death taxes and expenses. Such distributions will not be taxed as a dividend (i.e., ordinary income) but, rather, as a capital gain. [IRC § 303; *see* ¶ *7:243*]

(c) [2:240] **Freezing values for estate tax purposes:** The shareholders of a growing business can "freeze" the values of their interests for estate tax purposes by creating several classes of shares and making exempt gifts of shares.

1) [2:240a] **Example:** The owners of a closely-held corporation could create a class of voting preferred shares whose value would remain static; i.e., they might be entitled to specified dividends or liquidation priority, but would not further participate in future earnings or growth. They could also retain sufficient voting rights to assure management control. The remainder of the ownership interests (i.e., the right to the corporation's future earnings and growth potential) could be represented by a class of common shares (with or without voting rights), and tax-exempt gifts could be made of these shares. (See further discussion in connection with recapitalizations at ¶ *8:131 ff.*)

2) [2:240.1] **Caution—complex tax valuation rules:** However, the gift transfers of shares are subject to complex rules that seek an accurate gift tax valuation of the transferred interests, resulting in a relatively *high* valuation of the *transferred* interests and *low* valuation of the *retained* interests. In addition, the rules effectively require the original owners (i.e., transferors) to accept taxable dividends on the retained preferred stock. [IRC §§ 2701-2704]

2. [2:240.2] **Probate Proceedings (Ancillary Administration):** If the business owns real estate, the impact of probate proceedings should also be considered. An "*ancillary administration*" may be necessary where a partnership or sole

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

proprietorship owns real property in a state other than the deceased general partner's or sole proprietor's domicile (i.e., several probate proceedings may be pending concurrently). On the other hand, real estate held by a corporation or LLC is ordinarily irrelevant with respect to probate of a deceased shareholder's or LLC member's estate, since the entity, and not its shareholders or members, is the owner of the property (¶ *2:37.1*).

Cross-refer: For a comprehensive treatment of decedents' estates administration, including ancillary probates, see Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG).

SUMMARY
ADVANTAGES VS. DISADVANTAGES OF INCORPORATION

[2:241] The following briefly summarizes the materials covered above and in other parts of this Practice Guide as to the advantages and disadvantages of a corporation, as opposed to a pass-through entity (sole proprietorship, partnership or LLC). Each of the following factors bears consideration in choosing the form of business entity:

[2:242] Advantages of corporate form:

- Personal liability for business debts can be avoided (¶ *2:38*);
- Centralized management and control structure (¶ *2:67*);
- Continuity of existence (¶ *2:59*);
- Ownership interests more readily divisible and transferable (¶ *2:63*);
- The ability to be taxed like a partnership while preserving owners' limited liability (i.e., elect S corporation status; ¶ *2:119 ff.*);
- No limitations on deduction of losses from "passive activities" (except for certain closely-held corporations, and "personal service corporations"; ¶ *2:118.3 ff.*);
- If "passive activity" loss limitations apply, can still deduct such losses against active business income, ¶ *2:118.5* (except for personal service corporations, ¶ *2:118.15*);
- Opportunity for stepped-up basis on property contributed to corporation for stock (taxable incorporation) (¶ *2:167*);
- Right to select noncalendar fiscal year, enabling deferral of income tax on salary distributions to shareholders (¶ *2:114*);
- More deductible employee fringe benefits (group term life, sick pay, medical reimbursements, stock option/purchase plans, etc.) (¶ 2:215 ff.);
- Loss on IRC § 1244 stock treated as ordinary rather than capital loss, so that it can be written off against other taxable income (¶ *2:188*);
- Estate planning advantages (¶ *2:237 ff.*).

[2:243] Disadvantages of corporate form:

- Costs of formation and maintaining "corporateness" of enterprise (legal fees, accounting fees, etc.) (¶ *2:72*);
- Formalities required to avoid risk of shareholder liability for corporate debts (¶ *2:80*);
- "Double" tax on distributions of appreciated assets as dividends or on liquidation (¶ *8:1151 ff.*);
- Double taxation of same profits when distributed in form of dividends to shareholders (¶ *2:103*);

- Risk of penalty taxes on earnings and accumulations not distributed as dividends to shareholders (¶ *2:110*);
- Risk of disallowance of tax deductions for "unreasonable" salaries, interest or other expense payments to shareholders (¶ *2:106*);
- Section 269A limitations on personal service corporations (¶ *2:229*);
- Loss on sale or exchange of shares deductible only as capital loss unless § 1244 applies (¶ *2:187 ff.*);
- Inability to specially allocate income, losses or other tax attributes (¶ *2:11*).

  Cross-refer: For a comprehensive discussion of choice of entity from the point of view of pass-through entities (general partnerships, limited partnerships, LLPs and LLCs), see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 2.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 2-E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 2. Substantive Law Considerations in Choosing Business Entity: Tax and Nontax Factors

---

E. Professional Corporations—Special Considerations

- 1. [2:245.1] Corporation Rendering Professional Services Other Than as Professional Corporation
  - a. [2:245.2] Compare—most professionals cannot utilize LLC
- 2. [2:246] Rules of Corporate Law Applicable
  - a. [2:247] Formation requirements
    - (1) [2:248] Articles must contain special purpose clause
    - (2) [2:248.1] Special statement required in articles
    - (3) [2:249] Corporate name regulated
      - (a) [2:250] Name of licensed shareholders
      - (b) [2:251] Designating corporate status
      - (c) [2:252] Conflict of names
  - b. [2:253] Registration requirements
    - (1) [2:254] Procedure for registration
    - (2) [2:254.1] Annual renewal and report by law corporation
    - (3) [2:255] Grounds for suspension or revocation
    - (4) [2:255.5] Failure to register not ground for denial of professional fees
  - c. [2:256] Shareholder requirements
    - (1) [2:259] No delegating voting rights to outsider
    - (2) [2:260] Restrictions on transfer of shares
    - (3) [2:261] Effect of death or disqualification of shareholder
      - (a) [2:262] Comment
      - (b) [2:264] Buy-out agreements mandatory for some professions
      - (c) [2:265] Usual restrictions on share repurchases not applicable
        - 1) [2:266] Caution
    - (4) [2:266.5] Shareholder's fiduciary duty to comply with shareholder requirements
  - d. Requirements re directors and officers
    - (1) [2:267] For one and two-shareholder corporations
      - (a) [2:269] Comment
    - (2) [2:270] Regulations of state agencies
    - (3) [2:271] Special flexibility for medical corporations
  - e. [2:272] Malpractice liability
    - (1) [2:273] State Bar requirements for law corporations
      - (a) [2:275.1] Amount of security

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [2:276] Compare—other shareholder liability

3. [2:278] Tax Considerations re Professional Corporations

a. [2:279] Tax-free incorporation problems

b. [2:281.1] Calendar fiscal year

(1) [2:281.2] Three-month deferral election

c. [2:281.3] Cash basis accounting

d. [2:282] Tax advantages disallowed to "personal service corporations"

e. [2:283] Other grounds for disregard of corporate entity

f. [2:285] "Excessive" salary deductions

g. [2:286] Accumulated earnings tax

h. [2:287] Personal holding company tax

i. [2:290] Capital gain vs. ordinary income on sale of stock

(1) [2:291] Effect

(2) [2:293] Exceptions

j. [2:294] Capital gain vs. ordinary income on liquidation of corporation

(1) [2:295] Value of goodwill

(2) [2:296] Double tax on receivables

(a) [2:297] Similar treatment under state law

(3) [2:298] Recapture provisions

4. [2:300] Securities Law Considerations re Professional Corporations

a. [2:301] Federal securities laws

b. [2:302] California law

5. [2:310] Compare—Limited Liability Partnerships for Accountants, Attorneys, Architects, Engineers and Land Surveyors

a. Partnerships eligible to be LLPs

(1) [2:311] Professional firms

(2) [2:312] Partnerships "related" to *accounting* or *law* LLPs

b. [2:314] Liability shield

(1) [2:315] Security for claims requirement

(a) [2:316] Accounting and architecture firms

(b) [2:316.1] Engineering and land surveying firms

(c) [2:317] Law firms

c. [2:318] Election to convert to LLP

(1) [2:319] No relief from preexisting liabilities

d. [2:320] Registration

(1) [2:321] Minimum franchise tax on LLPs

(a) [2:321.1] First-year exemption

e. [2:322] State agency regulation

(1) [2:323] State Bar rules

(2) [2:324] Accountancy rules

(3) [2:325] Architects

(4) [2:326] Engineers and land surveyors

[2:244] Special considerations are involved in deciding whether to become a "professional corporation" under the Moscone-Knox Professional Corporation Act, Corps.C. § 13400 et seq. This Act permits professionals who are licensed under the Business and Professions Code (e.g., lawyers, physicians, dentists, accountants), the Chiropractic Act, the Osteopathic Act, and the Yacht and Ship Brokers Act to practice in the corporate form. [Corps.C. §§ 13401(a), 13401.3, 13403]

[2:245] A professional corporation may render its professional services only through individuals who are duly *licensed* in the particular profession involved (Corps.C. § 13405(a)); and, the corporation itself is subject to regulation by the state agency

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

charged with licensing such professional activity (Corps.C. § 13410(a)). For example, law corporations may render legal services only through persons who are licensed to practice law in California; and such corporations are subject to regulation by the State Bar of California (Bus. & Prof.C. § 6160).

• [2:245a] **Cross-Refer—Limited Liability Partnership Alternative:** California law permits *accountants, attorneys, architects, engineers and land surveyors* (and their affiliated service partnerships) to practice as a limited liability partnership, which offers the pass-through tax feature of partnerships and the liability shield of the corporate form. *See ¶ 2:310 ff.*

1. [2:245.1] **Corporation Rendering Professional Services Other Than as Professional Corporation:** Certain "professionals," such as engineers (see Bus. & Prof.C. § 6738), realtors (see Bus. & Prof.C. §§ 10158-10159.2), broker-dealers (see Corps.C. § 25210 et seq.) and investment advisors (see Corps.C. § 25230 et seq.), have always been permitted to conduct their activities as corporations. The Moscone-Knox Professional Corporations Act does *not* apply to corporations such as these, which are authorized to render professional services under other provisions of law. Such corporations are *not* "professional corporations" within the meaning of the Act. [See Corps.C. § 13402(a)]

However, if the Act provides the only authority to render certain professional services in corporate form, the corporation *must* be organized as a *professional* corporation. [See 75 Ops.Cal.Atty.Gen. 92 (1992)—legal aid clinic cannot organize as nonprofit public benefit corporation instead of professional corporation]

a. [2:245.2] **Compare—most professionals cannot utilize LLC:** Most licensed "professionals" are not permitted to render professional services as an LLC (*see ¶ 2:36.36 ff.*).

However, *accountants, attorneys, architects, engineers and land surveyors can operate as a limited liability partnership. See ¶ 2:310 ff.*

2. [2:246] **Rules of Corporate Law Applicable:** Subject to a few exceptions, professional corporations are subject to the same rules of corporate law as any other corporation. [Corps.C. §§ 102(a), 13404]

a. [2:247] **Formation requirements:** A professional corporation is formed in the same way as any other corporation (*¶ 4:1*), but subject to the following special requirements:

(1) [2:248] **Articles must contain special purpose clause:** A special purpose clause is prescribed for use by professional corporations, and must be set forth in its articles of incorporation:

> "The purpose of the corporation is to engage in the profession of _____ and any other lawful activities (other than the banking or trust company business) not prohibited to a corporation engaging in such profession by applicable laws and regulations." [Corps.C. § 202(b)(1)(B); *see ¶ 4:7*]

(2) [2:248.1] **Special statement required in articles:** The articles must contain a specific statement that the corporation is a professional corporation within the meaning of Part 4 of the Corporations Code. (Typically, "This corporation is a professional corporation within the meaning of Section 13400 et seq. of the Corporations Code of the State of California.") [Corps.C. §§ 202(b)(4), 13404]

(3) [2:249] **Corporate name regulated:** The state agency regulating the profession in which the corporation proposes to engage has the power to regulate the name which the corporation may adopt. [Corps.C. § 13409(a)]

(a) [2:250] **Name of licensed shareholders:** Some state regulatory agencies require the corporate name of a professional corporation to include the name of the person or persons licensed to render the professional services involved, while others permit a professional corporation to use a fictitious name. [See, e.g., Bus. & Prof.C. § 4998.2 (licensed clinical social worker corporation may operate under fictitious name so long as not false, misleading or deceptive)]

(b) [2:251] **Designating corporate status:** The state regulatory agencies also generally require that the name of a professional corporation denote its corporate status; i.e., that it contain the words "a professional corporation" or "law corporation" or "medical corporation," etc. [Corps.C. § 13409(a); see State Bar Rule 3.152(B)]

This is similar to the requirement for close corporations (Corps.C. § 202(a); *see ¶ 3:238*). But there is no such requirement as to other corporations (*¶ 4:4*).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [2:252] **Conflict of names:** The name chosen for a professional corporation cannot be "substantially the same" as the name of any other corporation. This poses problems for professional persons with similar names; e.g., if there are two "Mary Jones" law corporations.

The Secretary of State's policy is to permit the lawyer's name to be used as the corporate name, but with some variation, such as inclusion of a middle name or initial or the use of different *corporate* designations. For example, if the first corporation is "Mary Jones, a law corporation," the second corporation might be "Mary Susan Jones, a law corporation," or "Mary Jones, a professional corporation." [See 2 CCR § 21004.5(a)(3)]

b. [2:253] **Registration requirements:** Most professional corporations are required to register with the appropriate governmental agency regulating the profession in which the corporation intends to engage. They are permitted to render professional services only while a current certificate of registration is in effect. (But medical, dental, veterinary, architectural and certain other specified corporations are exempt from this requirement.) [Corps.C. §§ 13401(a) & (b), 13404]

(1) [2:254] **Procedure for registration:** Each state agency regulating professional corporations has its own registration procedures. E.g., registration as a law corporation requires filing of an application with the State Bar as set forth in State Bar Rule 3.152 of the State Bar Rules governing law corporations (State Bar Rule 3.150 et seq.).

(2) [2:254.1] **Annual renewal and report by law corporation:** Law corporations must renew their certificates of registration each year and must also file an annual report with the State Bar containing information as to their continued eligibility and compliance with State Bar rules. [Bus. & Prof.C. §§ 6161.1, 6163; State Bar Rule 3.156]

(3) [2:255] **Grounds for suspension or revocation:** Any of the following is ground for suspension or revocation of a professional corporation's registration certificate:

• *All* shareholders become disqualified from rendering professional services;

• Knowingly employing or retaining as an employee a person who is disqualified from rendering professional services;

• Violation of any statute applicable to professional corporations generally, or of any rule or regulation adopted by the state agency charged with regulating the profession involved;

• Any other ground for suspension or revocation specified in the Business & Professions Code relating to the particular profession involved (e.g., see Bus. & Prof.C. §§ 6161, 6163 and 6169 re grounds for suspension or revocation of a law corporation). [Corps.C. § 13408; see State Bar Rules 3.156(B), 3.160]

[2:255.1 - 2:255.4] ***Reserved.***

(4) [2:255.5] **Failure to register not ground for denial of professional fees:** A client may not invoke the corporation's failure to register as ground for refusing to pay (or for seeking a refund of) fees for services rendered. Generally, failure to register with the appropriate authority is remediable *by that authority*, whether by discipline or by a cease and desist order. Absent a showing of injury caused by the failure to register, denial (or disgorgement) of earned fees "is disproportionate to the wrong." [See *Olson v. Cohen* (2003) 106 CA4th 1209, 1215, 131 CR2d 620, 625 (law corporation not registered with State Bar at time legal services were performed); *Steven M. Garber & Assocs. v. Eskandarian* (2007) 150 CA4th 813, 819-820, 59 CR3d 1, 5 (same); and *Frye v. Tenderloin Housing Clinic, Inc.* (2006) 38 C4th 23, 48, 40 CR3d 221, 239 (nonprofit law corporation not registered with State Bar)]

c. [2:256] **Shareholder requirements:** The shares of capital stock of a professional corporation may be issued only to appropriately licensed persons; e.g., the shares of a law corporation may be issued only to active members of the State Bar or to attorneys duly licensed in other states. [Corps.C. § 13406; State Bar Rule 3.157] However, the shares of certain health and welfare-related professional corporations may be issued (subject to ownership restrictions) to members of other designated professions; e.g., licensed optometrists may be shareholders of podiatry corporations. [Corps.C. § 13401.5; see *Le v. Pham* (2010) 180 CA4th 1201, 1208-1209, 103 CR3d 606, 610-611 (noting shareholder restrictions per Bus. & Prof.C. § 4111 with respect to pharmacy corporations)]

[2:257] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[2:258] Persons who are not "eligible shareholders" of a professional corporation cannot exercise rights or privileges of a shareholder under the General Corporation Law. For example, lawyers who become "inactive" may no longer be "eligible shareholders" under the State Bar Rules governing law corporations, and hence may not be able to maintain action for involuntary dissolution of the corporation.

(1) [2:259] **No delegating voting rights to outsider:** The shareholders of a professional corporation are prohibited from delegating their voting rights (by proxy, voting trust or other arrangements) to anyone who is not a licensed shareholder of the same corporation. Any attempt to do so is *void*. [Corps.C. § 13406(a)]

(2) [2:260] **Restrictions on transfer of shares:** Shares in a professional corporation may be transferred only to another licensed person or back to the corporation. Any other transfer is *void*. Such restrictions on transfer must be noted on the share certificates. [Corps.C. §§ 13407, 418(a)(1); see *Le v. Pham* (2010) 180 CA4th 1201, 1209-1210, 103 CR3d 606, 611-612 (noting Corps.C. § 13407 restricts pharmacy corporation share transfers to licensed persons)]

(3) [2:261] **Effect of death or disqualification of shareholder:** If a shareholder dies or becomes disqualified to render professional services, the Code contemplates that the shareholder's shares will either be reacquired by the corporation or transferred to another licensed professional. In the case of a shareholder's death, this must occur within six months following the date of death; in the case of shareholder disqualification, within 90 days following the date of disqualification. *Otherwise, the corporation's registration certificate may be suspended or revoked* by the state agency regulating the profession; in which event, the corporation must cease forthwith the rendering of professional services. [Corps.C. § 13407]

(a) [2:262] **Comment:** These provisions make it incumbent upon professional corporations to have *buy-out agreements* with their shareholders (*see ¶ 3:187 ff.*). Otherwise, they may be unable to reacquire the shares or effect transfer to another licensed professional.

➪ [2:263] ***PRACTICE POINTERS:*** In negotiating and drafting the terms of the buy-out agreement, have the clients consider whether the price and terms for payment should differ depending on the triggering event—e.g., a greater price paid in the event of a shareholder's death than in the event of the shareholder's disbarment or disqualification, and perhaps a different price on retirement than upon voluntary withdrawal to continue in practice elsewhere or in competition with the corporation.

The Code provisions for repurchase or transfer of shares do *not* compel payment in full within the time limits specified. Thus, there is no reason that the buy-out agreement cannot provide for installment payments over a period of time (which is usually quite appropriate in the case of a disqualified or withdrawing shareholder).

Finally, where the buy-out may be triggered by an insurable event (e.g., a shareholder's death, incapacity, disability, etc.), consideration should be given to funding the repurchase agreement with insurance (life and/or disability) on the shareholder-employees of the corporation.

(b) [2:264] **Buy-out agreements mandatory for some professions:** In the case of law corporations (and certain other professional corporations), a buy-out agreement among the shareholders and the corporation is mandatory. The buy-out provisions must be set forth in the corporation's articles, bylaws or a separate written agreement. [State Bar Rule 3.157(E); see *Le v. Pham* (2010) 180 CA4th 1201, 1208-1209, 103 CR3d 606, 611 (noting Bus. & Prof.C. § 4154 authorizes Pharmacy Board to require pharmacy corporation bylaws to contain mandatory buy-out)]

(c) [2:265] **Usual restrictions on share repurchases not applicable:** Normally, a corporation cannot reacquire its own shares unless it has adequate retained earnings or its assets are not less than its liabilities immediately after the reacquisition. [Corps.C. § 500 et seq.; *see ¶ 7:10 ff.*]

However, a professional corporation may reacquire its own shares without any such restriction so long as at least *one share* remains issued and outstanding (i.e., held by some other licensed shareholder). [Corps.C. § 13407, 2nd para.]

1) [2:266] **Caution:** However, if the corporation is insolvent (or would be rendered insolvent by the repurchase), the transaction may be set aside under other provisions of law: as a *voidable transaction* under Civil Code § 3439 et seq.; or as a *preference or fraudulent transfer* under the Bankruptcy Code (11 USC §§ 547, 548).

[2:266.1 - 2:266.4] ***Reserved.***

(4) [2:266.5] **Shareholder's fiduciary duty to comply with shareholder requirements:** A shareholder of a professional corporation may have a fiduciary duty, both to the corporation and other shareholders, to comply with share ownership/ transfer requirements imposed by law and any shareholder buy-out agreement. This is especially so if a share transfer that

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

violates applicable law or the buy-out agreement could interfere with proper conduct of the business (e.g., through business closure following suspension or revocation of the corporation's registration). [See *Le v. Pham* (2010) 180 CA4th 1201, 1210-1211, 103 CR3d 606, 612-613—50% shareholder in pharmacy corporation breached fiduciary duty by attempting to transfer stock in violation of bylaw buy-out provision giving other 50% shareholder right of first refusal ("This is a case where the very attempt to transfer shares of stock itself precipitated the regulatory closure of the corporation's business")]

d. Requirements re directors and officers

(1) [2:267] **For one and two-shareholder corporations:** If a professional corporation has only a single shareholder (a licensed professional), it need have only one director—who must be such shareholder, and who must also serve as the corporation's president *and* treasurer. (But the other officers of the corporation need not be licensed professionals.) [Corps.C. § 13403]

[2:268] Where a professional corporation has only two shareholders (licensed professionals), it need have only two directors—who must be such shareholders and, between them, must serve as its president, vice-president, secretary and treasurer. [Corps.C. § 13403]

(a) [2:269] **Comment:** These provisions would not preclude a one- or two-shareholder professional corporation from having *more* than one or two directors, or additional officers who are *not* shareholders.

(2) [2:270] **Regulations of state agencies:** Except as just stated, the Code does *not* require officers or directors to be shareholders or licensed persons.

However, rules and regulations of the various state agencies regulating professional corporations may impose such requirements. [See, e.g., Bus. & Prof.C. § 6165—law corporation officers and directors must be licensed professionals]

(3) [2:271] **Special flexibility for medical corporations:** Special flexibility re officers and directors is accorded professional medical corporations. [See Corps.C. §§ 13401.5, 13403, 2nd para.]

e. [2:272] **Malpractice liability:** An important factor in deciding whether to incorporate a professional practice is the extent to which incorporation may limit the professional's liability for the acts of others. Obviously, a professional person cannot avoid personal liability for their *own* malpractice or tortious conduct through incorporation, since a tortfeasor is always liable for the tortfeasor's own acts, even if performed on behalf of another. [*T & R Foods, Inc. v. Rose* (1996) 47 CA4th Supp. 1, 8-10, 56 CR2d 41, 45-46 (quoting text)]

But, incorporation may enable professional persons to limit the *vicarious liability* they otherwise would incur for acts of their professional *partners*. For example, in the case of a medical partnership, Dr. A would normally have unlimited vicarious liability for his partner's negligence; but this liability may be substantially limited by incorporation, and the maintenance of specified insurance coverages. [See *T & R Foods, Inc. v. Rose*, supra (quoting text)]

(1) [2:273] **State Bar requirements for law corporations:** A similar result is available through incorporating a law practice. As a condition for registration of a law corporation, the State Bar requires that the corporation provide "security for claims for errors and omissions of the corporation or any person who practices law on behalf of the corporation on its behalf as an employee or otherwise." [State Bar Rule 3.158(A)]

[2:274] For law corporations registered prior to October 27, 1971, such security may consist *either* of malpractice insurance with specified limits *or* a written agreement by all shareholders jointly and severally guaranteeing payment of all malpractice claims against the corporation up to the same specified limits. [See State Bar Rule 3.158(A)]

[2:275] For law corporations registered on or after October 27, 1971, such written guarantee is required in all cases; i.e., even if the corporation obtains insurance in the prescribed coverage and limits. [State Bar Rule 3.158(A)(1)]

The effect is to limit the lawyer's liability for malpractice of other members of the corporation to the *limits specified* in the insurance or agreement. [See *T & R Foods, Inc. v. Rose* (1996) 47 CA4th Supp. 1, 9, 56 CR2d 41, 45 (quoting text)]

FORM: The State Bar's standard form Standard Law Corporation Guarantee (Attachment C-1) is available on the State Bar's website (*www.calbar.ca.gov/about-us/forms#attorneys*).

(a) [2:275.1] **Amount of security:** The amount of security for claims, typically satisfied through insurance, is not specified in the State Bar's Rules but, rather, in the State Bar's Law Corporation Guarantee Worksheet.

The security must be provided on both a *per claim* and *calendar year* basis. The required security *per claim* is determined by multiplying the number of persons practicing law on behalf of the law corporation (not the number of shareholders) by $50,000 (e.g., 5 x $50,000 = $250,000), up to a maximum of $500,000. The required security

for claims *per calendar year* is determined by multiplying the number of persons practicing law on behalf of the law corporation by $100,000 (e.g., 5 x $100,000 = $500,000), up to a maximum of $5,000,000. Even if the law corporation secures liability insurance in the required minimum amounts, a written guarantee must still be supplied, but the amount of the guarantee is offset by the amount of any insurance carried by the corporation or its shareholders. [Law Corporation Guarantee Worksheet, available on State Bar website (*www.calbar.ca.gov/about-us/forms#attorneys*)] (Note: The security requirement for law corporations is substantially less than for law LLPs; *see ¶ 2:317*.)

(2) [2:276] **Compare—other shareholder liability:** As to any other type of corporate debt or obligation, shareholders of a professional corporation are treated the same as shareholders of other corporations: i.e., they are not personally liable unless they have guaranteed the debts or there are grounds for "piercing" the corporate veil (*see ¶ 2:48 ff.*).

➪ [2:277] ***PRACTICE POINTER:*** As a practical matter, however, a professional corporation is often unable to obtain credit on its own. Most knowledgeable creditors or lenders will insist that the shareholders personally guarantee the corporation's lease commitments, equipment purchases or rentals, bank loans, etc.

3. [2:278] **Tax Considerations re Professional Corporations:** Corporate employees enjoy some tax-advantaged "fringe benefits" that are not available to proprietors, partners or LLC members (e.g., medical reimbursement plans, group term life insurance benefits, etc.; *see ¶ 2:215 ff.*). But, whether these benefits justify the increased costs and formalities of organizing and operating as a corporation is open to debate. In addition, there are some recognized areas of special tax concern to professional corporations.

Note—same tax rate as other corporations: Prior to 2018, professional corporations were taxed at a flat *35%* rate. Professional corporations are now taxed at the same 21% rate as other corporations (but corporate taxation may be avoided by electing S corporation status). *See ¶ 2:102.*

a. [2:279] **Tax-free incorporation problems:** There are risks in obtaining tax-free incorporation of a professional practice under IRC § 351 (*see ¶ 2:160*):

• [2:280] The risk that transfer of *accounts receivable* may be held taxable to the transferor—although the present policy of the IRS is not to tax such transfers in a bona fide IRC § 351 incorporation (Rev.Rul. 80-198, 1980-2 CB 113—upholding § 351 tax-free incorporation of cash-basis medical practice; *and see ¶ 3:343*).

Comment: Moreover, this risk can be avoided by having the transferor *retain* the accounts receivable, and pay taxes as the accounts are paid.

• [2:281] The risk that cash-basis *accounts payable* transferred to and assumed by the corporation *may not be deductible* by it when paid (see, however, Rev.Rul. 80-198, allowing such deductions; *¶ 3:343*).

Comment: There appears to be no real risk where *both* receivables and payables are transferred to the new corporation. And, of course, there is no risk of disallowance if the transferor *retains* the payables together with enough receivables to cover their payments. But there is a problem where the two are split: i.e., the transferor retaining the receivables and transferring the payables to the new corporation.

b. [2:281.1] **Calendar fiscal year:** Like partnerships and S corporations, professional corporations must use a *calendar* year for tax reporting purposes … unless they can demonstrate a valid business purpose for adopting a different fiscal year and the IRS Commissioner consents to the change. [IRC § 441(i)]

(1) [2:281.2] **Three-month deferral election:** A professional corporation may elect to adopt a different taxable year if this does not result in more than a three-month income deferral (thus facilitating September, October and November year-ends). But the professional corporation must make prescribed estimated tax payments every April 15 or risk losing its deferral election. [IRC § 444(c)]

c. [2:281.3] **Cash basis accounting:** Since a professional corporation is a qualified "personal service corporation" under the tax laws (*see ¶ 2:230*), it is not subject to the rules denying use of the cash method of accounting to C corporations (*see ¶ 2:118a*). Thus, it can keep its books and file its tax returns on the cash basis. [IRC § 448(b)(2), (d)(2)] (Most professional corporations customarily use the cash basis to report income and expenses.)

d. [2:282] **Tax advantages disallowed to "personal service corporations":** Significant *corporate* employee benefit tax advantages cannot be obtained by "personal service corporations" (those whose principal activity is to provide the services of persons owning 10% or more of its stock to a *single* other employer or firm). Such corporations may be disregarded as corporate entities, so as to disallow any tax advantage derived from the corporate form. [IRC § 269A, *discussed at ¶ 2:229*]

The effect is to *prevent* professional corporations from serving as *employees* or *partners* of other professionals—i.e., unless the corporation offers its services to a wide variety of clients, it will be disregarded for tax purposes.

e. [2:283] **Other grounds for disregard of corporate entity:** A professional corporation may also be vulnerable to a substance vs. form attack by the IRS, i.e., if the professional owners are not careful about maintaining the "corporateness" of their practice, the corporate entity will be disregarded for tax purposes. [See *Roubik v. Commr.* (1969) 53 TC 365]

➪ [2:284] ***PRACTICE POINTER:*** To reduce the risk of such attack, the *corporation* (not the professional person) should:

- Hold title to all tangible assets used in the practice (equipment, furniture, supplies, etc.) through the corporation;

- Bill for and receive in the corporate name all fees for services rendered;

- Incur and pay all expenses incurred in the practice;

- Be the employer of all personnel involved in the practice (preferably under employment contracts), and pay all social security, withholding and unemployment taxes, and workers' compensation insurance premiums incurred through the corporation; and

- Comply with corporate formalities generally (meetings of directors and shareholders, etc.), except if it is a statutory close corporation and has dispensed with such formalities.

f. [2:285] **"Excessive" salary deductions:** As in the case of any closely-held corporation, there is always a risk that tax-deductible salary payments to the shareholder employees will be challenged by the IRS as "excessive" compensation. The deductions may be disallowed in whole or in part as a "constructive dividend" (nondeductible return on invested capital). Year-end bonus payments are particularly suspect, and especially when distributed to all shareholders in proportion to their base salaries. [See *Brinks Gilson & Lione P.C. v. Commr.,* TC Memo 2016-20; *Pediatric Surgical Assocs., P.C. v. Commr.*, TC Memo 2001-81; *and ¶ 2:106*]

g. [2:286] **Accumulated earnings tax:** A professional corporation (or any other corporation) is subject to a special penalty tax if it has accumulated earnings in excess of *$150,000* (versus $250,000 for nonpersonal service corporations), unless a "reasonable future need" for such accumulation is shown (IRC § 531; *see ¶ 2:113*). Most small professional corporations would have difficulty in justifying such accumulations on ground of future business needs.

h. [2:287] **Personal holding company tax:** In many instances, more than 50% in value of stock of a professional corporation may be owned by five or fewer individuals, so that the ownership test is met for imposition of the penalty tax on personal holding companies (IRC § 542; *see ¶ 2:111*). In such cases, the difficult question is whether the professional corporation's income constitutes "personal holding company income."

[2:288] Amounts received for professional services *may* constitute "personal holding company income" if:

- Paid under an express or implied contract under which the client (rather than the corporation) can designate the particular employee who is to perform the services; and

- The designated individual owns 25% or more of the corporation's stock. [IRC § 543(a)(7)]

[2:289] **Comment:** To minimize this risk, the professional corporation (which meets the ownership test, ¶ 2:287) should have an agreement with each client (preferably in writing) that it reserves the right to designate the particular professional shareholder or employee who will render the services. [See Rev.Rul. 59-172, 1959-1 CB 144; *Claggett v. Commr.* (1965) 44 TC 503, acq. 1966-2 CB 4; Rev.Rul. 75-250, 1975-1 CB 172]

i. [2:290] **Capital gain vs. ordinary income on sale of stock:** Normally, corporate stock is a capital asset and thus the amount received by shareholders of a professional corporation on sale of their shares is taxable as a capital gain. The purchase price paid for such shares (by the corporation if it reacquires same, or by any other purchaser) is a nondeductible capital expense.

(1) [2:291] **Effect:** Most of the "value" attributable to the shares of a professional corporation is usually in its uncollected fees and receivables. If these were paid out as salary as collected, the corporation would have a deduction for the payments made and the shareholders would have ordinary income. But, by selling their shares, the selling shareholders can "bail out" their uncollected fees as a capital gain. At the same time, however, the corporation may have a higher tax to pay because it has no salary deduction to offset the income generated as the receivables are collected.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

➪ [2:292] ***PRACTICE POINTER:*** If it is desired that part of the funds paid be taxable as ordinary income to the selling shareholder (and deductible by the corporation), the agreement can be structured accordingly—i.e., all or part of the withdrawing shareholder's "share" of the cash-basis receivables, work-in-progress, goodwill, etc. can be designed as "*deferred compensation*," rather than part of the purchase price for the withdrawing shareholder's shares.

(2) [2:293] **Exceptions:** If the selling shareholder retains a share interest, actually or constructively, the distributions may be treated as *ordinary income* rather than capital gains. (*See ¶ 7:230*, dealing with redemptions.)

j. [2:294] **Capital gain vs. ordinary income on liquidation of corporation:** If for any reason the professional decides to liquidate the corporation and change back to a partnership or proprietorship, it may prove expensive from a tax standpoint.

Normally, amounts received by shareholders on complete liquidation of a corporation are treated as capital gains (*see ¶ 8:1152*, dealing with dissolution). But there are special problems in liquidating a professional corporation. These include:

(1) [2:295] **Value of goodwill:** Where there is any "goodwill" (e.g., continuation of professional activities by one or more of the shareholders), it has to be included as an asset distributed on liquidation. Thus, some value must be assigned to "goodwill" and tax paid thereon (additional capital gains).

(2) [2:296] **Double tax on receivables:** There is a risk of double taxation on uncollected receivables and work in progress (even if not yet billed). The IRS may require the corporation, prior to liquidation, to pay a tax on the then-value of its receivables and work in progress; and also require the shareholders to pay a capital gains tax on what they receive from the corporation. Thus, the receivables and work in progress would be taxed twice. [See *Williamson v. United States* (Ct.Cl. 1961) 292 F2d 524, 529-530]

(a) [2:297] **Similar treatment under state law:** Uncollected receivables may be subject to double taxation under state law as well. [See *Appeal of John E. Johns, D.D.S., Inc.* (Cal.St.Bd.Eq. 1987) CCH Cal. Tax Rep. ¶ 401-518, 1987 WL 59536—cash basis professional corporation recognizes gain on receivables it distributes upon liquidation]

(3) [2:298] **Recapture provisions:** If the corporation claimed investment tax credits, or took accelerated depreciation write-offs, these may be recaptured on liquidation, resulting in additional taxes. [See IRC §§ 47, 331, 1245, 1250]

➪ [2:299] ***PRACTICE POINTER:*** Instead of straight liquidation, consider a tax-free *split off* (under IRC §§ 355 and 368(a)(1)(D), *see ¶ 8:385*): i.e., a vertical division of the professional corporation into two or more separate corporations, each succeeding to an agreed part of the practice and assets. Such a split off can avoid most of the problems relating to valuation of goodwill, double tax incident to cash-basis receivables, etc.

4. [2:300] **Securities Law Considerations re Professional Corporations:** There is rarely any securities law problem with professional corporation shares. Appropriate exemptions are available under both federal and state laws.

a. [2:301] **Federal securities laws:** The issuance of professional corporation shares ordinarily is exempt from registration under the Securities Act of 1933—either under the intrastate offering exemption (SA § 3(a)(11); ¶ 5:81), or the private offering exemption (SA § 4(a)(2); ¶ 5:171), or the exemptions available under Regulation D (¶ 5:107). (Of course, even though exempt from registration, the anti-fraud provisions of the Securities Exchange Act of 1934 still apply; SEA § 10(b), SEC Rule 10b-5; *see ¶ 5:64*.)

b. [2:302] **California law:** The Commissioner of Financial Protection and Innovation (formerly the Commissioner of Business Oversight) has adopted a rule that exempts from the Corporate Securities Law any offer or sale of shares by a professional corporation (Commr. Rule 260.105.6). Again, however, the anti-fraud provisions of the Corporate Securities Law remain applicable. [Corps.C. §§ 25401, 25501; *see ¶ 5:390 ff.*]

[2:303 - 2:309] ***Reserved.***

5. [2:310] **Compare—Limited Liability Partnerships for Accountants, Attorneys, Architects, Engineers and Land Surveyors:** California also allows accountants, attorneys, architects, engineers (mechanical, electrical or civil, including geotechnical and structural) and land surveyors to operate their practices as a *limited liability partnership* (LLP). An LLP is a *general partnership* of accountants, attorneys, architects, engineers or land surveyors (or a service partnership affiliated with an *accounting* or *law* LLP, ¶ 2:312) that elects to be treated as an LLP by registering as such with the Secretary of State. [Corps.C. §§ 16101(a)(6), (8), §§ 16951-16962; Bus. & Prof.C. § 6738(a)]

Many of these professionals will undoubtedly find the LLP a very attractive alternative to the professional corporation, since an LLP shields the partners from vicarious liability, can operate more informally and flexibly than a corporation, and is accorded full partnership tax treatment.

• [2:310.1] ***Caution—1/1/26 "sunset" date for architecture, engineering and land surveying LLPs:*** Authorization for an LLP to engage in the practice of *architecture, engineering* or *land surveying* terminates on January 1, *2026*. [Corps.C. § 16101(a)(8)(A), (b), (c); see also Corps.C. § 16101 (Stats. 2019, Ch. 497; operative 1/1/26)]

Unless the Legislature extends or eliminates these termination dates, an *architecture, engineering* or *land surveying LLP* will have to reorganize as another entity *before 2026*.

a. Partnerships eligible to be LLPs

(1) [2:311] **Professional firms:** A California general partnership may register as an LLP if each of its partners is licensed to practice law, public accountancy, architecture, engineering or land surveying in California or another jurisdiction. [Corps.C. § 16101(a)(8)(A)]

(2) [2:312] **Partnerships "related" to *accounting* or *law LLPs:*** Also eligible for LLP treatment is a general partnership that is (a) "related" to an *accounting* or *law* LLP *and* (b) provides services "related or complementary" to the services provided by, or provides services or facilities to, that LLP. [Corps.C. § 16101(a)(8)(A)(iii)]

A partnership is "related" to an LLP if:

- It directly or indirectly controls, is controlled by, or is under common control with, the LLP;
- At least a *majority* of the *partners* in the LLP are also partners in the "related" partnership; *or*
- At least a majority *in interest* of the partners in each partnership holds interests in, or are members of, another entity and each partnership renders services pursuant to an agreement with the other entity. [Corps.C. § 16101(a)(8)(B)]

[2:313] *Reserved.*

b. [2:314] **Liability shield:** LLP partners have no vicarious personal liability for the debts or obligations of the partnership based on events or transactions occurring during the time the partnership is a registered LLP. Each partner is liable only for that partner's personal misconduct (or guaranties). [Corps.C. § 16306(c); see *Rappaport v. Gelfand* (2011) 197 CA4th 1213, 1230-1232, 129 CR3d 670, 682-684]

(1) [2:315] **Security for claims requirement:** However, the price paid for eliminating vicarious liability is the requirement that LLPs have a specified minimum net worth or, alternatively, provide insurance or collateral in specified amounts to cover malpractice claims. (Unless the partnership satisfies the net worth requirement, each partner automatically *guarantees* payment of any shortfall in the insurance or collateral amounts available for malpractice claims.) [Corps.C. § 16956(a)(1)(C), (2)(C), (3)(C) & (4)(C)]

(a) [2:316] **Accounting and architecture firms:** Accounting and architecture LLPs may provide the necessary security by maintaining one or a combination of the following:

- Liability insurance (either on a claims made or occurrence basis) of at least $1,000,000 plus $100,000 for each *licensed person* (not just partners) over five, up to a maximum coverage of $5,000,000 per year;
- Collateral held in trust or bank escrow and consisting of cash, certificates of deposit, T-bills, letters of credit, or insurance bonds in the amount of at least $1,000,000 plus $100,000 for each licensed person over five, up to a $5,000,000 maximum per year;
- A partnership net worth of at least $10 million, as confirmed annually to the Secretary of State by an authorized LLP member. [Corps.C. § 16956(a)(1), (3)]

(b) [2:316.1] **Engineering and land surveying firms:** Engineering and land surveying LLPs may provide the necessary security by maintaining one or a combination of the following:

• Liability insurance (either on a claims made or occurrence basis) of at least $2,000,000 plus $100,000 for each *licensed person* (not just partners) over five, up to a maximum coverage of $5,000,000 per year;

• Collateral held in trust or bank escrow and consisting of cash, certificates of deposit, T-bills, letters of credit, or insurance bonds in the amount of at least $2,000,000 plus $100,000 for each licensed person over five, up to a $5,000,000 maximum per year;

• A partnership net worth of at least $10 million, as confirmed annually to the Secretary of State by an authorized LLP member. [Corps.C. § 16956(a)(4)]

(c) [2:317] **Law firms:** Law firm LLPs may provide the necessary security by having one or a combination of the following:

• Liability insurance (either on a claims made or occurrence basis) of at least $1,000,000 plus $100,000 for each *licensed person* (not just partners) over five, up to a maximum coverage of $7,500,000 per year;

• Collateral held in trust or bank escrow and consisting of cash, certificates of deposit, T-bills, letters of credit, or insurance bonds in the amount of at least $1,000,000 plus $100,000 for each licensed person over five, up to a $7,500,000 maximum per year;

• A partnership net worth of at least $15 million, as confirmed annually to the Secretary of State by an authorized LLP member. [Corps.C. § 16956(a)(2); see *Hecht, Solberg, Robinson, Goldberg & Bagley v. Sup.Ct. (Panther)* (2006) 137 CA4th 579, 598-599, 40 CR3d 446, 460—confirmation filed with Secretary of State may be discoverable in civil litigation even though not admissible at trial (see Corps.C. § 16956(d)); *compare* ¶ *2:275.1* re law corporation security requirement]

c. [2:318] **Election to convert to LLP:** An existing partnership may convert to an LLP by affirmative vote of its partners possessing a *majority in interest* in *current profits* (or by such different vote as may be required in the partnership agreement). [Corps.C. § 16955]

(1) [2:319] **No relief from preexisting liabilities:** Conversion to an LLP will *not* provide partners *retroactive* relief from vicarious liability for any partnership debts or obligations incurred or arising out of events occurring prior to attaining LLP status. [See Corps.C. §§ 16306(c), 16955(b)(2), (3)]

d. [2:320] **Registration:** An LLP must be *registered* as such. Registration is effected by filing a written statement with the Secretary of State (accompanied by a $70 filing fee) setting forth the name and principal office address of the partnership, the name and address of its agent for service of process in California, a brief statement of the partnership business, and a statement that the partnership is registering as a registered limited liability partnership. [Corps.C. § 16953(a), (b); Gov.C. § 12189(a)]

FORM: The Secretary of State's standard form Application to Register a Limited Liability Partnership (LLP-1) is available online at the Secretary of State's website (*www.sos.ca.gov*).

(1) [2:321] **Minimum franchise tax on LLPs:** LLPs must pay the same annual $800 minimum franchise tax imposed on limited partnerships (¶ 2:97.1 ff.), LLCs (¶ 2:97.22 ff.) and corporations (¶ 2:102.2 ff.). [Rev. & Tax.C. § 17948(a)]

(a) [2:321.1] **First-year exemption:** LLPs that register on or after January 1, 2021, and before January 1, 2024, are exempt from the minimum franchise tax in their *first* taxable year. [Rev. & Tax.C. § 17948(e)(1); *see* ¶ 2:97.22a]

e. [2:322] **State agency regulation:** Like professional corporations, LLPs must register with, and are subject to the requirements of, the State agencies that govern them—i.e., the State Bar (for lawyers), the State Board of Accountancy (for accountants), the California Architects Board (for architects) and the Board for Professional Engineers, Land Surveyors, and Geologists (for engineers and land surveyors). [Corps.C. § 16953(h)]

(1) [2:323] **State Bar rules:** Patterned generally after the Law Corporations Rules (¶ *2:273 ff.*), the State Bar's LLP rules detail the registration procedures and requirements for law LLPs, including provisions for voluntary and involuntary termination and renewal of LLP status. [State Bar Rule, Limited Liability Partnership Rules 3.170-3.180]

(2) [2:324] **Accountancy rules:** The State Board of Accountancy does not have rules pertaining specifically to LLPs; rather, LLPs are subject to the provisions that govern partnerships generally (see Bus. & Prof.C. §§ 5072-5073). (For guidance, see the Board of Accountancy's website, *www.dca.ca.gov/cba*.)

(3) [2:325] **Architects:** The California Architects Board does not have rules pertaining specifically to LLPs. However, a licensed architect must file with the Board the current name and address of the LLP (or other business entity) through which the architect provides architectural services. [Bus. & Prof.C. § 5558; see Bus. & Prof.C. § 5535 ("person" includes LLP); 16 CCR § 134(c)(4) ("business entity" includes LLP)]

(4) [2:326] **Engineers and land surveyors:** The Board for Professional Engineers, Land Surveyors, and Geologists does not have rules pertaining specifically to LLPs. However, licensed individuals who render services in the form of an LLP (or other business entity) must file an Organization Record Form with the Board indicating the type of business entity, the place and date of organization, the names of all partners and other information. [See Bus. & Prof.C. §§ 6738 (engineers), 8729 (land surveyors); 16 CCR § 463; and organization record forms available on the Board's website at *www.bpelsg.ca.gov*]

Cross-refer: For a comprehensive treatment of limited liability partnerships, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG), Ch. 4.

[2:327 - 2:399] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 2-F

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki ‘Vicki’ Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 2. Substantive Law Considerations in Choosing Business Entity: Tax and Nontax Factors

F. Social Purpose Corporations (SPCs)

[2:400] A social purpose corporation (SPC, Corps.C. § 2500 et seq.) is a for-profit corporation that may pursue *social or environmental* objectives. In most respects, including taxation, it is treated as any other for-profit corporation. However, there are some significant differences. Most importantly, an SPC's business activities must be consistent with its “special purpose,” and directors are given considerable leeway in conducting the corporation's business without profit-making as the sole governing objective. *See detailed discussion in Ch. 9 Part I.*

[2:401 - 2:410] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 2-G

The Rutter Group | July 2024 Update

California Practice Guide--Corporations

Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 2. Substantive Law Considerations in Choosing Business Entity: Tax and Nontax Factors

---

G. Benefit Corporations

[2:411] A benefit corporation is a for-profit corporation that has the purpose of creating a "*general public benefit*" (see Corps.C. § 14600 et seq.). A benefit corporation is treated in most respects, including taxation, as any other for-profit corporation, but there are some important differences. Like SPC directors (¶ 2:400), a benefit corporation's directors need not pursue profits as the corporation's primary objective, but the benefit corporation goes beyond the SPC in requiring the directors to assess the corporation's performance against a "third-party standard." *See detailed discussion in Ch. 9, Part II*.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 3-A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

A. Where to Incorporate

1. [3:2] Filing Fees and Annual Reports
2. [3:3] State Taxes
3. [3:3.1] Securities Laws
4. [3:4] Corporate Laws
    a. [3:4.1] "Internal affairs" doctrine
        (1) [3:4.2] Examples
        (2) [3:4.3] Directors' duties
            (a) [3:4.4] Limitation—insider trading
            (b) [3:4.5] Limitation—directors of "pseudo-foreign corporations"
        (3) [3:4.6] Limitation—local state having "more significant relationship"
        (4) [3:4.7] Compare—"procedural" matters
    b. [3:5] "Pseudo-foreign corporations"
        (1) [3:6] California law governs
        (2) [3:6.1] When "pseudo-foreign" corporation becomes subject to California law
            (a) [3:6.2] When "pseudo-foreign" corporation no longer subject to California law
        (3) [3:7] Constitutionality?
            (a) [3:7a] Comment
        (4) Exceptions
            (a) [3:7.1] "Listed" companies
            (b) [3:7.2] Wholly-owned subsidiaries of exempt foreign corporations
        (5) [3:7.5] Duty to advise of pseudo-foreign corporation status

[3:1] Whenever the decision has been made to incorporate, a threshold consideration is *where* to incorporate: i.e., under which state's laws should the corporation be formed?

Corporate laws differ from state to state, in varying degrees. But, if the corporation is going to have significant business or shareholder "contacts" or "presence" in California, there is usually no reason to incorporate outside the State.

For the reasons discussed below (¶ 3:2 ff.), a California corporation is ordinarily the logical choice for a business that is "centered" here.

1. [3:2] **Filing Fees and Annual Reports:** An out-of-state corporation must "qualify" to do business in California (Corps.C. § 2105), which requires payment of filing fees to the Secretary of State in addition to whatever filing fees were paid in its state of incorporation. This duplication of filing fees can be avoided by forming a California corporation. Further, a foreign corporation qualified to do business in California must annually file with the Secretary of State an information statement (Corps.C. § 2117) comparable to the statement California corporations are required to file (*see ¶ 4:474 ff.*).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2. [3:3] **State Taxes:** An out-of-state corporation, doing business in California, will have to pay a franchise tax to the State of California (Rev. & Tax.C. § 23151). It may *also* have to pay a franchise tax in the state of its incorporation, even if not doing business there. Thus, incorporating elsewhere when planning to do business in California potentially exposes the corporation to taxation by two states.

3. [3:3.1] **Securities Laws:** The requirements of the California Corporate Securities Law apply to any offer or sale of a security "in this state," regardless of the issuer's state of incorporation (*see ¶ 5:195 ff.*).

4. [3:4] **Corporate Laws:** No matter where the corporation is incorporated, various provisions of the California General Corporation Law may nonetheless apply to the corporation. And a foreign corporation located or doing substantial business in California may find itself caught in conflicts between the corporate laws of California and its state of incorporation.

a. [3:4.1] **"Internal affairs" doctrine:** The internal affairs doctrine is a *conflict of laws* principle holding that only the corporation's *state of incorporation* should regulate the corporation's "*internal affairs*"—i.e., matters relating to the corporation's *organic structure* or *internal administration*. Stated otherwise, a corporation's "internal affairs" involve "matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders." [*Edgar v. MITE Corp.* (1982) 457 US 624, 645, 102 S.Ct. 2629, 2642; *Drulias v. 1st Century Bancshares, Inc.* (2018) 30 CA5th 696, 705, 241 CR3d 843, 851; *Lidow v. Sup.Ct. (International Rectifier Corp.)* (2012) 206 CA4th 351, 358-359, 141 CR3d 729, 733-734; Rest.2d Conflict of Laws § 302, Comment "e"; see *Greb v. Diamond Int'l Corp.* (2013) 56 C4th 243, 264-269, 153 CR3d 198, 214-219 & fn. 35]

(1) [3:4.2] **Examples:** "Internal affairs" traditionally governed by the corporate laws of the state of incorporation include:

- Steps taken in the course of the original incorporation;
- Election or appointment of directors and officers;
- Adoption of bylaws;
- Corporate aspects of share issuance and reclassification;
- Preemptive rights;
- Directors' and shareholders' meetings;
- Shareholders' rights to examine corporate records;
- Amendment of articles and bylaws;
- Shareholder standing to bring or maintain a derivative action (*Charter Township of Clinton Police & Fire Retirement System v. Martin* (2013) 219 CA4th 924, 934, 162 CR3d 300, 308; *Villari v. Mozilo* (2012) 208 CA4th 1470, 1479, 146 CR3d 556, 562, fn. 9, ¶ *6:618*); and
- Procedures for mergers, consolidations and other reorganizations. [See *Lidow v. Sup.Ct. (International Rectifier Corp.)* (2012) 206 CA4th 351, 359, 141 CR3d 729, 734; *State Farm Mut. Automobile Ins. Co. v. Sup.Ct. (Hill)* (2003) 114 CA4th 434, 442-447, 8 CR3d 56, 63-67—directors' decision not to pay dividends was "internal affairs" matter governed by law of state of incorporation; Rest.2d Conflict of Laws § 302, Comment "a"]

  Caution: Statutory and case law have applied *California* law, rather than the law of a foreign corporation's state of incorporation, to some matters found on the above list; *see* ¶ *3:6, 6:137*.

(2) [3:4.3] **Directors' duties:** California has partially codified the "internal affairs" doctrine. Directors of a foreign corporation doing business in California are liable for unauthorized dividends, share purchases or asset distributions, as well as for false certificates, reports, public notices "or other violation of official duty," according to the laws of the *state of incorporation*. [Corps.C. § 2116; see *Charter Township of Clinton Police & Fire Retirement System v. Martin* (2013) 219

CA4th 924, 934, 162 CR3d 300, 308—§ 2116 provides that law of state of incorporation "governs the liability of directors to the corporation and its shareholders"; *Villari v. Mozilo* (2012) 208 CA4th 1470, 1479, 146 CR3d 556, 562, fn. 9; also see *Drulias v. 1st Century Bancshares, Inc.* (2018) 30 CA5th 696, 706, 241 CR3d 843, 851-852, *discussed at ¶ 4:397.12 ff.*]

(a) [3:4.4] **Limitation—insider trading:** California's statutory prohibition on insider trading (Corps.C. § 25402) applies to directors of foreign corporations present in California; *see ¶ 6:388.5*.

(b) [3:4.5] **Limitation—directors of "pseudo-foreign corporations":** California corporate law governing the directors' *standard of care* (Corps.C. § 309) applies to directors of "pseudo-foreign corporations." [Corps.C. § 2115(b); *see ¶ 3:6*]

(3) [3:4.6] **Limitation—local state having "more significant relationship":** Although a matter may touch upon the corporation's "internal affairs," the law of the state of incorporation is *not* applied where another state has a "more significant relationship" to the parties and transaction at issue. [*Lidow v. Sup.Ct. (International Rectifier Corp.)* (2012) 206 CA4th 351, 359, 141 CR3d 729, 734 (*discussed further at ¶ 6:267.6*); *Vaughn v. LJ Int'l, Inc.* (2009) 174 CA4th 213, 225-226, 94 CR3d 166, 175-176; Rest.2d Conflict of Laws §§ 302, 309]

Indeed, the "more significant relationship" exception can be said to form the basis of the Corps.C. § 2115 "pseudo-foreign corporation," ¶ 3:5 ff.

(4) [3:4.7] **Compare—"procedural" matters:** The internal affairs doctrine does not extend to matters properly governed by local forum rules, such as determining whether an action is properly characterized as legal (triable by jury) or equitable (triable by the court). [*Central Laborers' Pension Fund v. McAfee, Inc.* (2017) 17 CA5th 292, 344-350, 225 CR3d 249, 294-300—suit brought in California alleging breach of fiduciary duty by Delaware corporation directors was governed by California law which determined action was equitable in nature and hence triable by court; *see ¶ 6:252.3*]

b. [3:5] **"Pseudo-foreign corporations":** Many (but not all) provisions of the California General Corporation Law expressly apply if the corporation has sufficient "presence" here. An out-of-state "unlisted" corporation (*see ¶ 3:7.1*) is treated as a "*pseudo-foreign corporation*," and thus subject to specified provisions of California law, if:

• More than half its business (based upon a three-factor formula including property, payroll and sales) is done in California (the "doing-business" test); *and*

• More than half of its voting securities are held of record by persons having addresses within the state (the "voting-stock" test). [Corps.C. § 2115(a); see *Kruss v. Booth* (2010) 185 CA4th 699, 715-723, 111 CR3d 56, 70-77; see also *State Farm Mut. Automobile Ins. Co. v. Sup.Ct. (Hill)* (2003) 114 CA4th 434, 448, 8 CR3d 56, 69]

(1) [3:6] **California law governs:** Such a "pseudo-foreign corporation" is subject to certain *enumerated* (but by no means all) provisions of the Corporations Code to the *exclusion* of the law of the state of incorporation. Many of these provisions relate to the corporation's "internal affairs" (*see ¶ 3:4.1 ff.*) and would not otherwise apply to foreign corporations. These provisions include such major shareholder protections as the shareholders' right to elect directors annually by cumulative voting (Corps.C. § 708; *see ¶ 6:137*), directors' duties of care to the corporation (Corps.C. § 309), limitations on indemnification of directors (Corps.C. § 317), and limitations on corporate distributions (Corps.C. §§ 500-505). [See Corps.C. § 2115(b); *Greb v. Diamond Int'l Corp.* (2013) 56 C4th 243, 251-252, 153 CR3d 198, 203-204]

(2) [3:6.1] **When "pseudo-foreign" corporation becomes subject to California law:** A "pseudo-foreign corporation" that meets both the Corps.C. § 2115(a) "doing-business" and the "voting-stock" tests (¶ *3:5*) does not immediately become subject to the enumerated provisions of California law. Rather, a time lag is imposed by statute. The corporation becomes subject to the enumerated provisions on the first day of the corporation's first income year commencing on or after:

• The 135th day of the income year immediately following the latest income year with respect to which the § 2115(a) tests have been met; *or*

• Entry of a final court order declaring that the § 2115(a) tests have been met. [Corps.C. § 2115(d); see *Kruss v. Booth* (2010) 185 CA4th 699, 719-723, 111 CR3d 56, 74-77 (noting time lag can be approximately 3 years)]

(a) [3:6.2] **When "pseudo-foreign" corporation no longer subject to California law:** A similar time lag is imposed when a "pseudo-foreign corporation" ceases to meet the Corps.C. § 2115(a) tests. The corporation ceases to be subject to the enumerated provisions of California law at the end of:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The first income year immediately following the latest income year with respect to which at least one of the § 2115(a) tests is not met; *or*

• The income year during which a final court order has been entered declaring that one of the § 2115(a) tests is not met (provided that no contrary order is entered before the income year ends). [Corps.C. § 2115(e); see *Kruss v. Booth* (2010) 185 CA4th 699, 722-723, 111 CR3d 56, 76-77]

(3) [3:7] **Constitutionality?** California courts have upheld the constitutionality of the "pseudo-foreign corporation" statute against equal protection, due process, and full faith and credit challenges. [See *Wilson v. Louisiana-Pacific Resources, Inc.* (1982) 138 CA3d 216, 222-224, 228-231, 187 CR 852, 856-858, 860-863 (imposing California cumulative voting requirements on Utah corporation); *Valtz v. Penta Investment Corp.* (1983) 139 CA3d 803, 806-810, 188 CR 922, 924-926 (applying California shareholders' inspection rights to Delaware corporation); see also *Greb v. Diamond Int'l Corp.* (2013) 56 C4th 243, 251-252, 153 CR3d 198, 203-204 & fn. 10]

But the Delaware Supreme Court has held that Corps.C. § 2115 runs afoul of the Commerce Clause, which prohibits multiple states from regulating subjects, such as the internal affairs of a corporation, that require *one uniform system of regulation*. The Court also ruled § 2115 violates the principle that a corporation's *internal affairs* should be governed *exclusively* by the law of the state of *incorporation*. [*VantagePoint Venture Partners 1996 v. Examen, Inc.* (Del. 2005) 871 A2d 1108, 1115-1118 (applying Delaware law treating all classes of stock as one class for purposes of voting on merger and rejecting application of § 2115 that would require approval by each class of stock and thereby allow one class to block merger); see *Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, S.A.* (Del. 2011) 34 A3d 1074, 1082]

(a) [3:7a] **Comment:** In view of the Delaware Supreme Court's refusal to apply Corps.C. § 2115, California investors in a foreign corporation having significant contacts in California should be cautious about relying on the statute's protections.

(4) Exceptions

(a) [3:7.1] **"Listed" companies:** Corps.C. § 2115 does *not* apply to foreign corporations having outstanding securities listed on the New York Stock Exchange, NYSE American (previously NYSE Amex), Nasdaq Global Market or Nasdaq Capital Market. [Corps.C. § 2115(c)]

(b) [3:7.2] **Wholly-owned subsidiaries of exempt foreign corporations:** Likewise exempted from treatment as a "pseudo-foreign corporation" are corporations whose voting shares are all owned (directly or indirectly) by a corporate parent *not* subject to Corporations Code § 2115. [Corps.C. § 2115(c)(2)]

[3:7.3 - 3:7.4] ***Reserved.***

(5) [3:7.5] **Duty to advise of pseudo-foreign corporation status:** A pseudo-foreign corporation must respond within 30 days of receiving a written request from any shareholder of record, officer, director, employee, agent or creditor inquiring whether the corporation is a pseudo-foreign corporation. Failure to truthfully respond risks penalties of $25 per day (maximum $1,500) from the date the request was received plus, in the court's discretion, court costs and reasonable attorney fees. [Corps.C. §§ 2115(f), 2200]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 3-B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

B. Planning Financial-Control Structure

1. [3:14] Allocating Financial Interests—"Debt" vs. "Equity"
    - a. [3:15] Basic distinction between "equity" and "debt"
        - (1) [3:17] Hybrid arrangements
    - b. [3:18] Choice depends on clients' objectives
        - (1) [3:19] Corporate control objective
        - (2) [3:20] Financial objectives
        - (3) [3:22] Flexibility
        - (4) [3:24] Consideration to be paid by investor
        - (5) [3:25] Tax objectives
    - c. [3:26] Counsel's responsibility re choice
    - d. Nontax factors affecting choice
        - (1) [3:28] Requirement that corporation issue some capital stock
        - (2) [3:29] Requirement that capitalization be "adequate" for expected liabilities
        - (3) [3:30] Subordination of shareholder-held debt if corporation insolvent
            - (a) [3:31] Example
        - (4) [3:32] Comment
    - e. [3:33] Tax factors affecting choice
        - (1) Taxability of interest vs. dividend distributions
            - (a) [3:34] Tax effect on recipient
            - (b) [3:34a] Tax effect on corporation
                - 1) [3:34.1] *Caveat*—no interest deduction on hybrid debt/equity instruments
        - (2) [3:35] Repayment of debt vs. repurchase of shares
        - (3) [3:36] Deductibility in event of loss
            - (a) [3:37] Loss on debt normally a capital loss
                - 1) [3:38] Exception
            - (b) [3:39] Loss on shares capital loss, unless IRC § 1244 applies
                - 1) [3:40] Ordinary loss under IRC § 1244
        - (4) [3:40.5] Potential tension among shareholders
2. [3:41] Tax Criteria as to "Debt" vs. "Equity"
    - a. [3:43] Case-by-case determination
        - (1) [3:44] Burden of proof on taxpayer
    - b. [3:45] Factors distinguishing debt from equity
        - (1) [3:46] Code-identified factors

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [3:47] Parties' intent to create debt
(3) [3:48] Problem with debt held proportionately to stock
(4) [3:49] Thin capitalization points to capital contribution
(a) [3:50] Safe ratios
(5) [3:51] Convertibility
(6) [3:53] Source of payment
(7) [3:54] Increased participation in management
(8) [3:55] Corporation's ability to borrow from commercial lenders
(9) [3:56] Fixed maturity date
c. [3:59] Loans guaranteed by shareholder may be treated as shareholder loans
(1) [3:60] *Caution*—dividend treatment
3. [3:66] Choice of Type of Security to Issue
a. [3:67] Debt securities
(1) [3:68] Conversion rights
(2) [3:69] Requirements where issue subject to qualification under Corporate Securities Law
(3) [3:72.1] Usury law limitation
(a) Exemptions
1) [3:72.2] Institutional lenders
2) [3:72.2a] Entity with $2 million in assets or issuing at least $300,000 in debt
3) [3:72.2b] Other exemptions available to corporations
(b) [3:72.3] Penalties for violations
(4) [3:72.5] Commercial Code requirements
b. [3:73] Equity securities (stock)
(1) [3:74] Types of equity securities
(a) [3:75] Determined by articles of incorporation
(b) [3:76] Lawful consideration for share issuance
(2) [3:77] Common stock
(a) [3:78] Voting rights
1) [3:78.1] Requirement that one class have full voting rights
2) [3:78.2] Shifting of voting rights
(b) [3:79] Financial rights
1) [3:80] It is possible, however, to…
2) [3:81] If there are several classes…
(c) [3:82] Caution—S corporation limited to one class of common stock
(3) [3:90] Preferred stock
(a) [3:91] Preferences dependent upon articles of incorporation
1) [3:92] Restrictions also dependent upon articles
(b) [3:93] Typical preferences
1) [3:94] Dividend rights
a) [3:94.1] Dividend rate and payment date
1/ [3:94.2] Caution—boot
b) [3:95] Mandatory or discretionary?
1/ [3:96] Example
2/ [3:97] Compare
c) [3:98] Cumulative or noncumulative?
1/ [3:99] “Cumulative”
2/ [3:100] “Noncumulative”
2) [3:102] Liquidation rights
a) [3:103] Example

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

3) [3:104] Participation rights
a) [3:105] Provisions limiting participation rights
b) [3:107] Compare—drafting participation provisions
c) [3:110.1] Tax advantage of participation rights
4) [3:111] Voting rights
a) [3:112] Compare—right to approve fundamental changes affecting preferred shares
b) [3:113] Example
c) [3:114] Voting rights on dividend default
1/ [3:115] Example
d) [3:116] Additional voting rights
5) [3:119] Conversion rights
a) [3:120] Purpose
b) [3:121] Drafting considerations
c) [3:124.1] Compare—conversion at *corporation's* option
(c) [3:125] Protections required by Commissioner of Financial Protection and Innovation
1) [3:126] Cumulative dividends
2) [3:127] Prohibitions on common stock dividends
3) [3:128] Voting rights while dividends in arrears
4) [3:129] Approval of adverse change
5) [3:130] Anti-dilution
(d) [3:131] Redemption rights
1) [3:132] Redemption at option of corporation
a) [3:133] Purpose
2) [3:134] Redemption at option of shareholder
a) [3:135] Purpose
3) [3:136] Drafting considerations
4) [3:137] Sinking fund provisions
5) [3:138] Compare—exercise of redemption rights dependent on funds available
6) [3:138.1] *Caution*—redeemable shares taxable as "boot"
(e) Tax-planning considerations re preferred stock
1) [3:139] No help in avoiding double taxation
2) [3:140] No S election
3) [3:141] Section 1244 treatment now available
4) [3:142] May jeopardize tax-free incorporation
4. [3:144] Allocating Control of Corporation
a. [3:145] Cumulative voting for directors
(1) [3:146] Right exists as matter of law
(a) [3:147] No "staggered" terms of office
(b) [3:148] Exception for "listed" corporations
1) [3:148.1] Adverse effect on minority shareholders
(c) [3:148.2] Exception for statutory close corporations
(d) [3:148.3] Exception for mutual water companies
(e) [3:148.5] Limitation on removal of individual directors
(2) [3:149] Prerequisites
(3) [3:150] Mechanics
(a) [3:151] Formula
(b) [3:152] Example
(c) [3:153] Shorthand expression of formula
b. [3:155] Articles may create several classes of voting shares

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [3:156] Purpose
(2) [3:157] Example
(3) [3:157.1] Limitation on removal of directors
c. [3:158] Articles may require greater-than-majority shareholder or director vote
d. [3:159] Shareholders' pooling agreements and voting trusts
(1) [3:159.1] Shareholder voting agreements (“pooling agreements”)
(a) [3:159.3] Enforcement
(b) [3:159.4] “Self-executing” agreements
1) [3:159.5] Irrevocable proxies
(2) [3:159.8] Voting trusts
(a) [3:159.10] Formalities
(b) [3:159.11] Duration
(c) [3:159.12] Scope of authority conferred on trustee
(d) [3:159.14] Rights of holders of voting trust certificates
(e) [3:159.15] Securities law considerations
1) [3:159.16] Special exemption for trust certificates reflecting stock split or dividend
5. [3:160] Typical Allocations
a. [3:161] Equal investors who will be equally active
b. [3:165] Equal investors who will NOT be equally active
c. [3:168] Some investors supplying capital, others supplying services
6. [3:176] Preventing Changes in Control-Financial Structure
a. [3:177] Limits on further issuance of voting stock
(1) [3:178] Supermajority board approval requirement
(2) [3:179] Supermajority shareholder approval requirement
b. [3:180] Preemptive rights
7. [3:182] Providing for Future Changes in Financial Structure
a. [3:183] Stock options to younger participants
b. [3:184] Employment contracts with buy-back provisions
c. [3:185] Repayment to cash investors

[3:8] Following a decision to incorporate, in California or elsewhere, the first step is to plan the financial and control structure of the proposed corporation.

Such planning normally involves the following steps:

• First, it must be determined what each of the participants is contributing *to* the enterprise (and its *value*, if other than cash; *see ¶ 3:307*).

• Second, what the parties each expect to derive *from* the enterprise must be considered in the way of salaries, dividends, etc.; as well as their expectations re management and control (*see ¶ 3:144*).

• Next, the various alternatives that might accommodate these objectives must be considered, together with the tax ramifications of each such alternative.

• Finally, a plan must be designed that allocates financial interests and control in accordance with the clients' objectives, *at the least possible cost tax-wise*.

[3:9 - 3:12] *Reserved.*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

➪ [3:13] ***PRACTICE POINTER:*** Planning takes time and requires careful consultation with the client. Since each deal differs somewhat, beware of recommending some "standard" or "usual" arrangement, or relying too heavily on agreements used in some previous deal. Such arrangements may prove unworkable for the clients, necessitating later revisions. Once shares are issued, amendments are costly and expensive, and may also be subject to qualification requirements under the Corporate Securities Law (as "recapitalizations"; *see ¶ 8:119*).

1. [3:14] **Allocating Financial Interests—"Debt" vs. "Equity":** In allocating financial interests in the corporation, the basic choice is between *equity* investment (stock ownership) and *debt* investment (loans to the corporation). Often, the plan for initial capitalization will include *both* "equity" and "debt" investment.

a. [3:15] **Basic distinction between "equity" and "debt":** "Equity" participation involves an *ownership* interest in the corporation. Normally, it is reflected by issuance of shares of stock, either common or preferred, with such rights as provided in the articles of incorporation (*see ¶ 4:28*). Control of the corporation normally belongs to those holding a majority of its voting stock (although other devices for allocating control may exist, *see ¶ 3:144 ff.*).

On the other hand, "debt" participation involves a loan of money or other property to the corporation. Unlike equity investments, "debt" must be repaid, with interest, at some fixed maturity. Holders of debt instruments are *creditors* of the corporation. As such, they are entitled to priority over the shareholders in claims against the corporate assets; but are *not* ordinarily entitled to any voice in management and control.

[3:16] ***Reserved.***

(1) [3:17] **Hybrid arrangements:** Sometimes, the distinction between "equity" and "debt" becomes blurred. For example, debt instruments (notes, bonds, debentures) may be issued with *conversion* rights that entitle the holder to exchange them for an equity position (common or preferred stock); *see ¶ 3:119*. And "loans" may be made to the corporation on such favorable terms (e.g., modest interest, extended maturity) that they may be treated as an "equity" investment for tax and corporate law purposes; *see ¶ 3:28, 3:41*. [See generally, *Hewlett-Packard Co. v. Commr.* (9th Cir. 2017) 875 F3d 494, 495-496]

b. [3:18] **Choice depends on clients' objectives:** It is up to the clients to decide whether, and how much of, their investment in the corporation shall be in the form of "equity" (shares) or "debt" (loans). Their decision will usually reflect a *balancing* of various separate objectives:

(1) [3:19] **Corporate control objective:** Corporate control ordinarily rests with the shareholders, not the creditors of the corporation. The shareholders have the right to elect the board of directors, and thus ultimately control management of the corporate business.

(2) [3:20] **Financial objectives:** "Equity" investors look primarily for increased value of their investment. Shareholders may have dividend rights, but dividend payment is usually dependent on earnings and profits; and even then, rests within the sound discretion of the board of directors. Thus, shareholders have no guarantee of *any* return on the investment or right to repayment. Their main objective is the *potential for profit* when the shares are sold or the corporation liquidated.

On the other hand, there is no potential for enhanced value with a straight "debt" investment. Rather, the lender settles for a fixed right to repayment of the lender's investment at some future time, and to receipt of interest in the interim, all in accordance with the terms of the debt instrument. Payment will be due regardless of the availability of earnings and profits, and will not be dependent on action by the board of directors.

[3:21] ***Reserved.***

(3) [3:22] **Flexibility:** Share issuance offers only limited flexibility, since all shares of the same class or series must have the same rights and restrictions. Although the board of directors retains considerable discretion as to the *consideration* for which shares may be issued (*see ¶ 3:318*), once the shares are issued, control generally rests with the shareholders holding a majority of the voting shares. It is difficult, therefore, to cut different deals for different investors without creating multiple classes of stock (e.g., voting and nonvoting common, or one or more classes of preferred stock).

On the other hand, there is tremendous flexibility with debt investments. If necessary, each debt-holder (creditor) can be given a different deal: i.e., different interest rate, maturity date, conversion rights, etc. Certain debt-holders can be

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

made more secure by providing collateral to secure their loans; others can be made less secure by providing that their loans can be subordinated to other financing.

[3:23] ***Reserved.***

(4) [3:24] **Consideration to be paid by investor:** Another advantage of debt investment is that it can be issued for any lawful consideration—including some forms that might *not* be allowed for stock issuance: e.g., promises to perform *future* services, or covenants not to compete, or proprietary “knowhow” (*see ¶ 3:308*).

(5) [3:25] **Tax objectives:** The clients will normally seek the most favorable tax treatment for the corporation and themselves individually. *See ¶ 3:33 ff.*

c. [3:26] **Counsel's responsibility re choice:** Although the choice between equity and debt rests ultimately with the clients, it is counsel's responsibility to make sure they understand the tax and nontax ramifications of their decision. Typically, clients will expect counsel to *recommend* a financial structure that best accomplishes the various objectives above (¶ 3:18 ff.).

➪ [3:27] ***PRACTICE POINTER:*** Because of the many possible alternatives and their differing consequences, this may be your most important responsibility in organizing a corporation. The complexity of the plan usually depends on the similarity of the client's objectives. The more diverse their interests, the more complex the financial and control structure will become.

Usually, the plan you suggest should *balance* the various objectives above (¶ 3:18 ff.). It should accommodate whatever control structures are desired by the parties, while at the same time protect their respective financial interests—at the least possible cost tax-wise.

d. Nontax factors affecting choice

(1) [3:28] **Requirement that corporation issue some capital stock:** To complete its formation as a separate entity, the corporation must issue *some* capital stock—i.e., if its only capital consists of loans, the corporate structure is incomplete, as there are no shareholders to exercise voting rights, etc. In such event, the advantages sought by incorporation (e.g., tax benefits, avoidance of personal liability, etc.) would be jeopardized.

(2) [3:29] **Requirement that capitalization be “adequate” for expected liabilities:** Further, to avoid exposing shareholders to alter ego liability, the corporation must be capitalized (through a combination of equity and loans) in an amount that is “adequate” to give it *independent substance* in relation to third party obligations likely to be incurred in connection with the corporation's business. If the amount of stock issued is “trifling compared with the business to be done and the risks of loss,” the corporate veil may be “pierced” and those operating the corporation held personally liable for its debts. [*Minton v. Cavaney* (1961) 56 C2d 576, 580, 15 CR 641, 643—attorney who formed corporation and served as officer and director held personally liable for its torts where corporation never issued shares; *see ¶ 2:53*]

➪ [3:29.1] ***PRACTICE POINTER:*** Although there is no “bright-line” test re what constitutes “adequate” capital, the initial shareholders should, at a minimum, capitalize the corporation with sufficient funds and other assets necessary to enable the business to reach its projected break-even (based on their own *reasonable and good faith estimates* as to when projected business income will cover estimated expenses).

If they do so, the initial shareholders should be able to avoid alter ego liability based on under-capitalization even if their projections turn out wrong and the business fails (as so many do).

(3) [3:30] **Subordination of shareholder-held debt if corporation insolvent:** If the capitalization is “too thin” (i.e., mostly loans from shareholders, very little capital stock), the shareholder-held debt may be *subordinated* to the claims of third-party creditors of the corporation. The effect is to give the outside creditors “first crack” at the corporation's assets.

This may be true even if the shareholders' creditor claims are secured and the other creditors' claims are unsecured. [See *Taylor v. Standard Gas & Elec. Co.* (1939) 306 US 307, 322-323, 59 S.Ct. 543, 550; and *Pepper v. Litton* (1939) 308 US 295, 312, 60 S.Ct. 238, 248]

Subordination is an equitable remedy, and therefore usually requires a showing of bad faith in the under-capitalization, or *breach of fiduciary duty* to the creditors involved.

(a) [3:31] **Example:** X loaned personal funds to his wholly-owned corporation. It had very little capital and soon was insolvent. X then used its remaining funds to repay the corporation's debt to him, leaving it totally without assets for the other creditors. X was held to owe a *fiduciary duty* to the other creditors not to take personal advantage of the

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

corporate assets, and therefore liable to them for the funds obtained. [*Commons v. Schine* (1973) 35 CA3d 141, 145, 110 CR 606, 609]

(4) [3:32] **Comment:** There is no set formula as to the amount of capital stock that must be issued to avoid the risks enumerated above (¶ 3:28 ff.). It should be noted, however, that a debt vs. equity ratio that would suffice for *tax* purposes (*see ¶ 3:50*) *may or may not* suffice to prevent "piercing" the corporate veil and subordination of shareholder-held debt on insolvency. These are equitable doctrines and are discretionary with the court; they depend largely on the *degree* of injustice or bad faith involved in the particular case.

e. [3:33] **Tax factors affecting choice:** The tax effects of debt and equity investments are entirely different. Deciding which one to use, or the correct "mix" of debt and equity, requires an analysis of the goals of the corporation and its investors.

(1) Taxability of interest vs. dividend distributions

(a) [3:34] **Tax effect on recipient:** Interest is includible in the payee's ordinary income for federal income tax purposes and hence is taxable at rates up to 40.8% (37% ordinary income rate plus 3.8% investment income surtax). [See IRC § 61(a)(4)]

On the other hand, dividends from U.S. corporation are taxed at a maximum rate of 23.8% (20% capital gain rate applicable to dividends plus 3.8% investment income surtax). [IRC §§ 1(h)(11), 61(a)(7); *see* ¶ 2:99 ff.]

(b) [3:34a] **Tax effect on corporation:** Interest payments on corporate debt are *deductible* by the corporation (subject to certain limits in corporations having annual gross receipts of more than $30 million in 2024, as indexed for inflation; *see ¶ 2:108.2*). In contrast, dividend distributions to the shareholders are *not* deductible. [IRC § 163(a); see *Hewlett-Packard Co. v. Commr*. (9th Cir. 2017) 875 F3d 494, 496; *Indmar Products Co., Inc. v. Commr.* (6th Cir. 2006) 444 F3d 771, 776]

1) [3:34.1] ***Caveat—no interest deduction on hybrid debt/equity instruments:*** The corporation may not deduct any "interest" paid on a debt instrument if:

- a *substantial amount* of the *interest or principal* is payable in or convertible into *equity* (e.g., stock) of the issuer or a related party; *or*

- substantial principal or interest on the debt is determined by reference to the value of the issuer's or a related party's *equity; or*

- the debt is part of a *plan* to pay equity to the holder (e.g., nonrecourse debt secured by stock). [IRC § 163(*l*)]

(2) [3:35] **Repayment of debt vs. repurchase of shares:** Repayment of the loan by the corporation results in no taxable income to the payee; it is merely a return of capital.

In contrast, corporate payments to repurchase outstanding shares may, under some circumstances, be treated as a dividend to the shareholders and thus be taxable (at rates equal to capital gain rates) to the extent of the corporation's *earnings and profits*. [IRC § 301(a),(c); *see ¶ 7:228*]

(3) [3:36] **Deductibility in event of loss:** There may also be differences, as between debt and equity investments, in the deductibility of any loss sustained if the investment proves unsuccessful.

(a) [3:37] **Loss on debt normally a capital loss:** In most cases, a loss on shareholder loans to the corporation will be treated as a "nonbusiness" loss; i.e., a *capital* loss—it can be used to offset capital gains, but otherwise is deductible only up to $3,000 per year. [IRC §§ 166(d), 1211]

1) [3:38] **Exception:** If it can be shown that the investor was in the *business of loaning money* to others (admittedly, a rare case), the loss on the investor's loans to the corporation would be deductible in full against other income as an ordinary loss. Whether there is a sufficiently close connection between the loan to the corporation and the lender's own trade or business is a question of fact in each case. [*Whipple v. Commr.* (1963) 373 US 193, 204, 83 S.Ct. 1168, 1175—loss on loan to corporation from controlling shareholder treated as "nonbusiness" *capital* loss]

(b) [3:39] **Loss on shares capital loss, unless IRC § 1244 applies:** Since corporate stock is a capital asset, loss on its sale or worthlessness is a capital loss (i.e., deductible against ordinary income only up to $3,000 per year) … *unless* the stock qualifies as "Section 1244" stock. [IRC §§ 165(g), 1211]

1) [3:40] **Ordinary loss under IRC § 1244:** As discussed earlier (*¶ 2:188*), § 1244 is a special measure designed to encourage investment in the stock of small corporations. It permits shareholders to deduct their losses on such stock

against ordinary income *up to $50,000* per year ($100,000 for married taxpayers filing jointly). Losses in excess of that amount are treated as capital losses. [IRC § 1244(b)]

[3:40.1 - 3:40.4] ***Reserved.***

(4) [3:40.5] **Potential tension among shareholders:** Clearly, the most important tax differences between debt and equity are the deductibility of interest by the corporation (*¶ 3:34a ff.*) and the taxation of dividends at rates equal to the lower capital gain rates (*¶ 3:34*). Some shareholders, particularly those who are active in the business, may wish to raise additional capital through the sale of *debt:* The interest payments will reduce the corporation's *taxable* income and hence increase the amount left over for dividends (or for payment of salary and/or bonuses).

Whether other investors, particularly passive ones, will accept debt instruments depends on whether they prefer a "guaranteed" return of their capital (i.e., loans) to the risks and potential rewards associated with equity. Ultimately, the "mix" of corporate debt and equity will be a matter of the parties' desires and negotiating strengths.

2. [3:41] **Tax Criteria as to "Debt" vs. "Equity":** As stated above (¶ 3:33 ff.), there are usually significant tax advantages to investments in the form of debt rather than equity. However, neither the courts nor the Internal Revenue Service are bound by the taxpayers' characterization of their investment as "debt" or loans to the corporation. [IRC § 385(c)(1)] If the capitalization is "too thin" the IRS may treat all or some portion of the "debt" as stock … so that "interest" deductions claimed by the corporation will be disallowed (see IRC § 163(a)—deduction for interest on indebtedness); and "loan repayments" treated as taxable dividends to the shareholders.

➪ [3:42] ***Caveat—debt securities as "boot":*** Debt securities issued in connection with a tax-free incorporation under IRC § 351 will be treated as *"boot"* … resulting in taxation of gain realized by the transferor at the time of incorporation. (The same is true for redeemable preferred stock that has the characteristics of "debt"; *see ¶ 3:340.1 ff.*) [IRC § 351, *discussed at ¶ 3:331 ff.*]

a. [3:43] **Case-by-case determination:** Whether an instrument represents debt or an equity investment for income tax purposes depends on the facts and circumstances of each case. No particular fact is conclusive. [*John Kelley Co. v. Commr.* (1946) 326 US 521, 530, 66 S.Ct. 299, 304; *Hewlett-Packard Co. v. Commr.* (9th Cir. 2017) 875 F3d 494, 497-499; *NA General Partnership & Subsidiaries v. Commr.*, TC Memo 2012-172—"Our objective is not to count the factors, but rather to evaluate them"; Rev.Rul. 83-98, 1983-2 CB 40]

(1) [3:44] **Burden of proof on taxpayer:** Transactions between a corporation and controlling shareholders are subjected to "close scrutiny." The burden of establishing that amounts advanced to the corporation were *loans* rather than capital contributions rests with the *taxpayer*. [*Hardman v. United States* (9th Cir. 1987) 827 F2d 1409, 1412; *Bauer v. Commr.* (9th Cir. 1984) 748 F2d 1365, 1368; *Calumet Indus., Inc. & Subsidiaries v. Commr.* (1990) 95 TC 257, 285-286]

b. [3:45] **Factors distinguishing debt from equity:** The Code authorizes the IRS to adopt regulations establishing criteria for determining whether an investment in a corporation shall be treated as stock or debt, and identifies five factors that may be included in the regulations. The IRS regulations largely leave the determination to common law. [IRC § 385(a); Treas.Reg. § 1.385-1(b)—treatment of investment as stock or debt determined based on common law except as otherwise provided in Code or regulations]

• [3:45.1] **No further regulatory changes:** Effective May 14, 2020, the IRS finalized the debt-equity regulations under Section 385 by implementing the 2016 proposed regulations without any substantive changes, essentially maintaining the status quo for the debt-equity rules under Section 385. This includes the removal of regulations that had established strict documentation requirements for purported debt obligations among related parties to be treated as debt. [TD 9897, 85 FR 28867-01, 2020 WL 2473366; see TD 9880, 84 FR 59297-01, 2019 WL 5684028]

Notwithstanding the removal of the documentation regulations, the need to document lending transactions is still present, especially in intercompany transactions.

(1) [3:46] **Code-identified factors:** Although the IRS defers to common law, the five Code factors have nevertheless been relied on for guidance and, as such, have been assimilated into the common law. [See *Hewlett-Packard Co. v. Commr.* (9th Cir. 2017) 875 F3d 494, 498 (enumerating 11 factors overlapping with Code factors); *Bauer v. Commr.* (9th Cir. 1984) 748 F2d 1365, 1368 (Code factors used as guidance even though enacted after facts of case arose); Rev.Rul. 83-98, 1983-2 CB 40; *Lease v. Commr.*, TC Memo 1993-493 (enumerating 13 factors overlapping with Code factors)]

The Code-identified factors are:

"(1) whether there is a written *unconditional promise* to pay on demand or on a specified date a sum certain in money in return for an adequate consideration … and to pay a fixed rate of interest,

"(2) whether there is *subordination* to or preference over any indebtedness of the corporation,

"(3) the *ratio of debt to equity* of the corporation,

"(4) whether there is *convertibility* into the stock of the corporation, and

"(5) the *relationship* between holdings of stock in the corporation and holdings of the interest in question." [IRC § 385(b) (emphasis added)]

(2) [3:47] **Parties' intent to create debt:** Although no single factor is determinative in distinguishing debt from equity, courts have stated that the ultimate question is whether the parties had a *genuine intention to create a debt*. The various factors thus become relevant in determining whether that intention comported with the *economic reality* of the transaction. [*Hewlett-Packard Co. v. Commr.* (9th Cir. 2017) 875 F3d 494, 498-499; *Calumet Indus., Inc. & Subsidiaries v. Commr.* (1990) 95 TC 257, 285-286; Rev.Rul. 83-98, 1983-2 CB 40; see *Delta Plastics, Inc. v. Commr.*, TC Memo 2012-172]

In assessing the parties' intent, the *name* given to the instruments is taken into consideration; and the *lack of formal debt instruments* militates against finding a bona fide debt. [*Hardman v. United States* (9th Cir. 1987) 827 F2d 1409, 1412-1413; *Calumet Indus., Inc. & Subsidiaries v. Commr.*, supra, 95 TC at 287]

(3) [3:48] **Problem with debt held proportionately to stock:** Loans will appear more like equity when the lenders are also shareholders and the amount of the debt is *substantially proportionate* to the shareholders' respective stock interests in the corporation. [See *Hardman v. United States* (9th Cir. 1987) 827 F2d 1409, 1414; *Calumet Indus., Inc. & Subsidiaries v. Commr.* (1990) 95 TC 257, 286-287; *Delta Plastics, Inc. v. Commr.*, TC Memo 2012-172]

Indeed, a loan from a *sole* shareholder is more likely to look like equity than debt. [*NA General Partnership & Subsidiaries v. Commr.*, TC Memo 2012-172]

(4) [3:49] **Thin capitalization points to capital contribution:** A high ratio of debt to equity tends to show the debt obligation is unrealistic or beyond the corporation's ability to perform. Debt may be regarded as *excessive* in relation to equity if the corporation's financial structure would not be reasonably satisfactory to a bank or other outside commercial lender. [See *Hardman v. United States* (9th Cir. 1987) 827 F2d 1409, 1414; *Delta Plastics, Inc. v. Commr.*, TC Memo 2012-172; *Nachman v. Commr.*, TC Memo 1996-288; compare *PepsiCo Puerto Rico, Inc. v. Commr.*, TC Memo 2012-269, 2012 WL 4207299, *19, *31—"'thinness' of capital structure in relation to debt" among 13 factors considered to determine whether advance agreements constituted debt or equity (citing *Dixie Dairies Corp. v. Commr.* (1980) 74 TC 476, 496)]

(a) [3:50] **Safe ratios:** As a general rule of practice among corporate and tax counsel, debt is not considered excessive if the corporation's aggregate or *overall* debt (including debt to outside creditors) does not exceed *10 times* its equity; *and* if the total debt to *shareholders* does not exceed *three times* its equity. [See *Bauer v. Commr.* (9th Cir. 1984) 748 F2d 1365, 1368-1370—where shareholders made series of loans to closely-held corporation, overall debt-to-equity ratio of no more than 7.7 to 1 and insider (i.e., shareholder-held) debt-to-equity ratio of 3.6 to 1 held not excessive; *Nachman v. Commr.*, TC Memo 1996-288; compare *Delta Plastics, Inc. v. Commr.*, TC Memo 2012-172—start-up's initial 26 to 1 debt-to-equity ratio not excessive in view of principals' business knowledge and experience that reduced ratio to 4 to 1 in 3 years]

Thus, shareholders may *lend* up to 75% of the initial capital contributions to the corporation without losing debt treatment … so long as the debt instruments otherwise qualify as bona fide debt and the terms of the instruments are complied with (e.g., shareholders do not waive interest or extend maturities).

(5) [3:51] **Convertibility:** Debt bearing a convertibility feature that, by its economic terms, all but assures the debt will be converted into stock is very likely to be treated as a capital contribution. [See Rev.Rul. 83-98, 1983-2 CB 40; *and* ¶ *3:34.1* re nondeductibility of interest]

[3:52] ***Reserved.***

(6) [3:53] **Source of payment:** A "debt" will tend to resemble equity where repayment of principal, or where the amount or rate of "interest," is explicitly or implicitly tied to earnings (e.g., cash advances will be repaid when corporation is able to pay). The debt will also resemble equity if payments are linked to the dividends paid on the corporation's stock (e.g., payment of dividends triggers payment of "interest"). In such circumstances, the "lender" acts "as a classic capital investor *hoping* to make a profit, not as a creditor expecting to be repaid regardless of the company's success or failure." [*Calumet Indus., Inc. & Subsidiaries v. Commr.* (1990) 95 TC 257, 287-288, quoting *Matter of Larson* (7th Cir. 1988) 862 F2d 112, 117 (emphasis in original); *Hardman v. United States* (9th Cir. 1987) 827 F2d 1409, 1412-1414; *Lease v. Commr*., TC Memo 1993-493; Rev.Rul. 83-98, 1983-2 CB 40—"debt" resembled equity where more than 65% of future annual yield was based on level of discretionary dividends paid on stock; compare *Hewlett-Packard Co. v. Commr*. (9th Cir. 2017) 875 F3d 494, 499—preferred stock was actually loan notwithstanding "dividends" contingent upon earnings where earnings were so "highly predictable" as to be "all but predetermined"]

(7) [3:54] **Increased participation in management:** A "loan" will appear more like a capital contribution where the "debt" results in an increase in the creditor-shareholder's *voting rights* or percentage *interest* in the corporation. [See *Hardman v. United States* (9th Cir. 1987) 827 F2d 1409, 1413; *Delta Plastics, Inc. v. Commr.*, TC Memo 2012-172; also see *Lease v. Commr.*, TC Memo 1993-493]

(8) [3:55] **Corporation's ability to borrow from commercial lenders:** If a corporation is able to borrow from outside sources, the transaction has the appearance of a bona fide debt and indicates the shareholder acted in the same manner toward the corporation as an ordinary reasonable creditor. Funds contributed to a corporation that is financially-strapped or unable to secure outside financing without shareholder guarantees are more likely to be treated as equity. [*Hardman v. United States* (9th Cir. 1987) 827 F2d 1409, 1411, 1413; *Calumet Indus., Inc. & Subsidiaries v. Commr.* (1990) 95 TC 257, 287; *Deja Vu, Inc. v. Commr.*, TC Memo 1996-234]

(9) [3:56] **Fixed maturity date:** A fixed maturity date points to a loan rather than equity. [See *Hewlett-Packard Co. v. Commr.* (9th Cir. 2017) 875 F3d 494, 498-499 & fn. 3—preferred stock that lacked economic sense after set date had "de facto" maturity date which indicated loan rather than equity]

[3:57 - 3:58] ***Reserved.***

c. [3:59] **Loans guaranteed by shareholder may be treated as shareholder loans:** The foregoing "debt vs. equity" factors (¶ 3:45 ff.) may apply to *third-party* loans that have been *personally guaranteed* by the shareholders. If the loans are considered as being made to the *shareholder*, rather than to the corporation, the shareholder will be treated as contributing the loan proceeds to the capital of the corporation—i.e., the loans will be considered equity. [See *Plantation Patterns, Inc. v. Commr*. (5th Cir. 1972) 462 F2d 712, 718-719]

(1) [3:60] ***Caution—dividend treatment:*** If a shareholder-guaranteed loan is recast as equity, "interest" *and principal* payments made by the corporation on such loan could be treated as *dividends* to the shareholder under IRC § 301—even though paid to the third-party creditor. Thus, the corporation would get *no deduction* for the payments, and the shareholder would end up being *taxed on payments made to someone else.*

#. [3:61] ***PRACTICE POINTERS:***

• *Be conservative* in planning the debt vs. equity structure of a closely-held corporation. If too high a debt-to-equity ratio is established, you risk having *all* of the debt reclassified as stock. Stick with the "safe harbor" of no more than 75% of investment as debt—i.e., a three to one debt-equity ratio (*see ¶ 3:50*).

• *Be realistic* about the *terms* of the debt instruments. They should reflect, insofar as possible, terms that might be reached in arm's length negotiations with independent lenders. Thus, the interest rate and maturity should reflect what would be available to the corporation in the marketplace. While a variable interest rate is permissible, the rate should be explicitly pegged to a reasonable and objectively-verifiable standard, such as "two points above prime." (But also note the possibility of *usury* limitations; *see* ¶ 3:72.1 ff.)

- *Avoid* hybrid instruments (convertible or contingent) unless they are absolutely critical to accomplishing your clients' business objectives.

- Pay close attention to *formalities* in preparing the debt instruments. Set forth fully the specific amount owed, terms of payment, maturity date, rights on default, etc. The instruments should make it appear, insofar as possible, that the loan is made in an “arm's length” transaction.

- In cases where operating assets are being transferred to the corporation, instead of selling the assets to the corporation for debt instruments, consider having the shareholder retain title and *simply lease the assets* to the corporation. Since no debt instrument will be issued, there is no risk that it may be classified as stock. Thus, the lease payments made by the corporation will clearly be deductible if reasonable in amount.

[3:62 - 3:65] ***Reserved.***

3. [3:66] **Choice of Type of Security to Issue:** Assuming the decision is made as to how much of the initial capitalization will be “debt” and how much will be “equity,” the next question is what *type* of debt or equity security to issue … and particularly, what rights will attach thereto.

a. [3:67] **Debt securities:** The corporation may issue various types of instruments to evidence its obligation to repay loans of money or to pay for property received. Such instruments are usually in the form of *promissory notes;* although, for more sophisticated debt transactions, they may be in the form of *bonds* or *debentures.* (Note: The terms “bonds” and “debentures” may be used interchangeably; *either* may be secured by a lien on specific corporate assets.)

(1) [3:68] **Conversion rights:** Like preferred stock (¶ *3:119*), debt securities may carry conversion rights. Thus, the holder of the bond or note may be given the *option* of converting the holder's claim against the corporation into an ownership interest (common or preferred stock).

(2) [3:69] **Requirements where issue subject to qualification under Corporate Securities Law:** If the debt securities are being issued to the public or are otherwise subject to qualification under the Corporate Securities Law (*see ¶ 5:195 ff.*), certain minimum protections are required by the Commissioner of Financial Protection and Innovation (formerly the Commissioner of Business Oversight).

- [3:70] If the debt securities are *convertible* into stock, or issued with stock warrants or options, the conversion or warrant normally must contain appropriate *anti-dilution provisions* (restricting further stock issuances). [Commr. Rule 260.140.6]
- [3:71] If the debt is not convertible into stock, the instrument should normally provide for a *sinking fund*, and appropriate restrictions on the corporation's creating senior debt or payment of dividends to the shareholders. [Commr. Rule 260.140.4]
- [3:72] If the debt securities are being offered and sold without restrictions to any individual or class of persons (i.e., “open qualifications”), the instrument should comply with provisions of the Trust Indenture Act of 1939 (15 USC §§ 77aaa-77bbbb). [Commr. Rule 260.140.5]

(3) [3:72.1] **Usury law limitation:** Practitioners should be aware that the protections of the California usury law apply to *corporate* borrowers. Thus, unless the lender (i.e., purchaser of corporate debt securities) is *exempt*, the interest rate on corporate debt instruments should not exceed the usury law interest rate limitation on commercial loans (10% per year or a maximum of 5 percentage points above the local Federal Reserve discount rate in effect on the 25th day of the month before the loan is made or agreed to, whichever is earlier). [See Cal. Const., Art. XV, § 1; Civ.C. §§ 1916-1 to 1916-5; and generally *Hardwick v. Wilcox* (2017) 11 CA5th 975, 978, 217 CR3d 883, 886]

(a) Exemptions

1) [3:72.2] **Institutional lenders:** Most institutional lenders (e.g., banks, insurance companies) are exempt from the usury law. Noninstitutional lenders (i.e., individuals) are generally *not exempt* (notable exception: licensed broker-dealers, see Corps.C. § 25211.5). [See Cal. Const. Art. XV, § 1]

2) [3:72.2a] **Entity with $2 million in assets or issuing at least $300,000 in debt:** A special exemption exists where certain debt securities are issued by an entity (including a corporation, LLC and limited partnership that does not have an individual serving as a general partner) or are *guaranteed* by such an entity that is an *affiliate* of the issuer (per Corps.C. §§ 150 and 25118(e)(1)). The debt securities and the purchasers and holders thereof are exempt from the usury law where:

• The issuer or guarantor has *total assets* of at least *$2 million* according to its most recent financial statements, which must be (i) as of a date not more than 90 days before issuance of the debt and (ii) prepared in accordance with *either* generally accepted accounting principles *or* SEC requirements (regardless of whether SEC requirements apply to the corporation); *or*

• The debt securities have an *aggregate face amount* or, if issued at a discount, *aggregate purchase price* of at least *$300,000.* [Corps.C. § 25118(a), (b)]
Limitation: However, this exemption is available only if:

• The purchasers have a *preexisting personal or business relationship* with any of the issuer's (or in the case of a guaranty, with any of the guarantor's) *officers*, *directors, controlling persons or* (in the case of an LLC) *managers* (as determined under the § 25102(f) limited offering exemption, ¶ 5:256 ff.); *or*

• The issuer and the purchasers, or the guarantor and the purchasers, by reason of their own business and financial experience or that of their professional advisers, could reasonably be assumed to have the *capacity to protect their own interests* (also as determined under § 25102(f), provided that a purchaser may designate their attorney as a professional adviser even where the attorney is compensated by the entity). [Corps.C. § 25118(f), (g)]
3) [3:72.2b] **Other exemptions available to corporations:** Corporate debt securities and the purchasers or holders thereof are also exempt from the usury law if:

a) The debt securities are *qualified with the Commissioner of Financial Protection and Innovation*; *or*

b) The debt securities are sufficiently well rated by a nationally recognized rating agency (e.g., Standard and Poor's or Moody's Investors Service); *or*

c) The issuer corporation has any security listed (or approved for listing) on a national securities exchange or the Nasdaq Global Market, Nasdaq Global Select Market or Nasdaq Capital Market; *or*

d) The issuer is a "reporting company" under the Securities Exchange Act of 1934 (*¶ 5:17*) and meets certain financial requirements; *or*

e) The issuer is a wholly-owned subsidiary of a corporation meeting the requirements of either of the preceding two paragraphs c) or d). [Corps.C. §§ 25116, 25117; see Corps.C. § 25100(o); Commr.Rel.No. 87-C (revised 2009)]
(b) [3:72.3] **Penalties for violations:** Debt instruments violating the usury law are void as to the interest. The borrower may recover all interest paid and obtain treble damages from the lender. Moreover, willful violations may constitute a felony. [See Civ.C. §§ 1916-2, 1916-3; *Hardwick v. Wilcox* (2017) 11 CA5th 975, 979, 991, 217 CR3d 883, 886, 895-896—action to recover usurious interest subject to CCP § 339 two-year limitations period commencing when debtor pays *entire* principal]
➪ [3:72.4] ***PRACTICE POINTER:*** To avoid the usury limitations, the issuer should consider qualifying a debt issuance with the Commissioner of Financial Protection and Innovation (*see ¶ 5:315 ff.*) if the availability of an exemption is unclear (e.g., can the purchasers of the issuer's notes or their professional advisers reasonably be assumed to have the capacity to protect the purchasers' interests in connection with the purchases?).
(4) [3:72.5] **Commercial Code requirements:** In addition, corporate debt securities may be subject to the requirements of Divisions 3 or 8 of the California Commercial Code. Among other things, these provisions govern the form, content and enforceability of "notes" and "securities." [See Comm'l C. §§ 3101 et seq., 8101 et seq.]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b. [3:73] **Equity securities (stock):** Equity securities represent the permanent capital invested in the corporation, normally in shares of common or preferred stock. The holders of such securities are the owners of the corporation, although they do not own any specific assets of the corporation or have only an indirect interest in the assets as a whole. Moreover, their claims to the corporate assets in event of liquidation will always be junior to the claims of debt holders (creditors).

(1) [3:74] **Types of equity securities:** In planning the corporate structure, the basic choice is between *common stock* and *preferred stock*. These are the only two types of "pure" equity security. (Debt securities that are convertible into stock are "hybrid" securities, in that they may be treated as equity for certain purposes—e.g., under tax or securities laws.)

(a) [3:75] **Determined by articles of incorporation:** If several classes of securities are contemplated, authorization therefor must appear in the articles of incorporation. Further, the articles must normally spell out the rights, preferences and privileges of each class. (Otherwise, all shares would have the same rights.) [Corps.C. §§ 203, 400, 401; *see ¶ 4:35, 4:46*]

(b) [3:76] **Lawful consideration for share issuance:** Broadly, either common or preferred shares can be issued for any consideration determined reasonable by the board of directors. (The only exceptions are that shares may not be issued solely for *future services* or for an *unsecured* promise to pay money.) [Corps.C. § 409(a); *see ¶ 3:307*]

(2) [3:77] **Common stock:** Where only one class of stock is authorized, that class is "common" no matter what it is called (e.g., "capital stock"). Where the articles authorize several classes of stock, the class which has *no* priority or preference over any other is the common stock.

(a) [3:78] **Voting rights:** Control of the corporation usually rests with the common shareholders. Unless the articles provide otherwise, the common shares carry voting rights. Through these voting rights, the common shareholders elect the directors, who manage the corporation. Thus, indirectly at least, they control the corporation.

1) [3:78.1] **Requirement that one class have full voting rights:** The articles may create *non*voting common stock, provided there is some other class or series outstanding that carries full voting rights (i.e., there must always be at least one class or series of shares that has the right to elect and remove directors). [Corps.C. § 400(a)]

• ***FORM:*** Optional Articles Provision Authorizing Voting and Nonvoting Common Stock, *see Form 4:A.1a*.

2) [3:78.2] **Shifting of voting rights:** Alternatively, the articles may provide for *shifting* voting rights from the common shares to another class or series on the happening of some contingency (e.g., voting rights to preferred shares in the event of nonpayment of their dividends; *see ¶ 3:114*).

(b) [3:79] **Financial rights:** Common shares generally represent the right to the residual equity in the corporation: i.e., after the claims of creditors and of all other stockholders having priority have been paid in full, whatever is left belongs to the common shareholders. This is true both with respect to dividends and to distributions on liquidation of the corporation. (*See ¶ 8:944*.)

1) [3:80] It is possible, however, to create a class of common shares *not* entitled to any dividends or distributions upon liquidation, and thus having no real financial or economic interest in the corporation. (Example: A special class of voting shares created and issued *to prevent deadlock* between holders of other voting shares, but without conferring any economic participation in the corporation.) [See Corps.C. § 400(a); *Lehrman v. Cohen* (Del. 1966) 222 A2d 800, 806-808]

2) [3:81] If there are several classes of common stock (e.g., "Class A" and "Class B") and one class has priority or preferences in dividends or liquidation, the class with the priority is in effect *preferred stock*, no matter what it is called. (But it may still be treated as "common" stock for tax purposes.)

(c) [3:82] **Caution—S corporation limited to one class of common stock:** If the corporation intends to be taxed as an S corporation, so that losses can be "passed through" to the shareholders, *only common stock* can be issued. Although distinctions as to *voting rights* are permitted in the shares issued by an S corporation, there can be *no* preferences as to dividends or liquidation distributions. [IRC §§ 1361-1379; *see ¶ 2:145*]

[3:83 - 3:89] ***Reserved.***

(3) [3:90] **Preferred stock:** Preferred stock is a class of shares having some sort of priority or preference over another class of shares. There may be several classes or series of preferred stock (e.g., "Preferred A" and "Preferred B"), one with distinct priorities over the other, and both with priorities over the common.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Typically, preferred stock entitles the holder to priority as to receipt of dividends and distributions upon liquidation, but carries no (or limited) voting rights. Thus, its use is appropriate for an investor or group of investors who are primarily interested in securing a fixed return on their investment, and to whom voting rights or allocation of power is not significant.

Keep in mind, however, that preferred stock is still part of the equity ownership of the corporation. It is *not* a debt (even as to dividend arrearages; *see ¶ 3:99*).

(a) [3:91] **Preferences dependent upon articles of incorporation:** All shares are created equal except as otherwise specifically provided in the articles of incorporation. [Corps.C. § 203] Thus, merely classifying shares as "preferred" confers no special rights upon them. The rights, preferences, privileges and restrictions of each class (or series) must be spelled out in the articles; or, the articles must confer upon the board of directors the authority to determine same.

• ***FORM:*** Optional Articles Provision Authorizing Common and Preferred Stock "In Blank" (Board to Fix Attributes), *see Form 4:A.1i*.

1) [3:92] **Restrictions also dependent upon articles:** Conversely, there are no restrictions upon preferred shares, unless stated or authorized in the articles. Thus, it becomes essential to *limit voting rights and dividend participation rights*, or the preferred stock will have the same rights as the common (*see ¶ 3:104*).

(b) [3:93] **Typical preferences:** The following are the preferences or priorities most commonly given to preferred stock. (As stated above (¶ 3:91), these rights exist only if stated or authorized in the articles of incorporation.)

1) [3:94] **Dividend rights:** The most important preference normally given is priority as to receipt of dividends from the corporation.

• ***FORM:*** Optional Articles Provisions Establishing Dividend Preferences (Mandatory or Discretionary, Cumulative or Noncumulative), *see Form 4:A.1c*.

a) [3:94.1] **Dividend rate and payment date:** First of all, the *amount* of the dividend preference must be stated, and so must the *payment period*—i.e., the times when the dividend must be declared and paid (quarterly, semi-annually, annually).

It is most common to state the amount as a *dollar figure*. If instead, a percentage figure or other measure is to be used, the articles must clearly indicate how the measure is determined (e.g., dividend on preferred shares "shall be twice the amount of dividends paid on all Common Shares").

1/ [3:94.2] **Caution—boot:** Where the dividend rate is tied to interest rates, commodity prices or similar indices, the stock may be deemed "nonqualified preferred stock" which, if issued as part of a § 351 tax-free exchange, may be taxable as "boot." *See ¶ 3:340.1 ff.*

b) [3:95] **Mandatory or discretionary?** The articles must state whether dividends on the preferred are mandatory or merely *discretionary* with the board of directors.

Normally, the declaration of dividends, even on preferred stock, is made discretionary with the board of directors.

1/ [3:96] **Example:** "The holders of the Preferred Stock shall be entitled to receive dividends at the rate of $_____ per annum, payable in cash quarterly or at such other intervals *when, as and if the board of directors so determines.* Such dividends shall be payable before any dividends are declared or paid on the Common Stock."

This language does not itself compel the board to declare dividends on the preferred—even if there are profits or other lawful sources of funds available to pay them.

2/ [3:97] **Compare:** But the articles may provide that the preferred stock dividends are *mandatory*. In such event, the shareholders can sue to compel payment *provided* the corporation may *lawfully* pay the dividends. [Corps.C. § 500; *see ¶ 7:10 ff.*]

The following language can be used for this purpose: "Dividends on the Preferred Stock shall be payable, *whether or not* earned, to the extent that the corporation may lawfully pay such dividends."

c) [3:98] **Cumulative or noncumulative?** The articles must also state whether the preferential right to dividends is cumulative or noncumulative.

1/ [3:99] **"Cumulative"** means that if the dividend is not paid with respect to any dividend period, the preference carries forward to future dividend periods and must be paid (together with any current preference) before any dividends are paid on junior classes of stock.

For example, the articles may state: "Dividends on the Preferred Shares shall be cumulative, so that if dividends required to be paid on said shares for any year or years shall not have been paid, the amount of the deficiency shall be paid in full, without interest, together with any dividends due for the current year, before any distribution of any kind shall be paid to the holders of the Common Shares."

However, the articles may permit dividends to be paid on junior classes of stock notwithstanding any dividend arrearages on the preferred stock. (But such a provision would severely limit the attractiveness of cumulative dividends. While dividends may still cumulate, payment of the cumulative amount would hinge largely on any enforcement provisions conferred on preferred shareholders by the articles.) [Corps.C. § 402.5(c); *see* *¶ 7:22*]

2/ [3:100] **"Noncumulative"** means that if the dividend is discretionary (*see ¶ 3:95*), and if not declared by the board, the preference is lost for that dividend period; i.e., it does *not* carry over to future dividend periods.

For example, the articles may state: "Dividends on the Preferred Shares shall be noncumulative, so that if dividends on said shares are not declared by the board of directors with respect to any fiscal year, the right thereto shall terminate with respect to such fiscal year, and the corporation shall have no further obligation or liability as to such dividends."

➪ [3:101] ***PRACTICE POINTER:*** If the articles are ambiguous, preferred stock dividend rights may be deemed to be *noncumulative* … because all shares are deemed equal unless the articles specifically provide otherwise (Corps.C. § 203; ¶ 4:46).

2) [3:102] **Liquidation rights:** Preferred stock is also usually given priority to the assets of the corporation on liquidation (after, of course, the creditors have been paid). Again, the articles of incorporation must state or authorize any such preference.

a) [3:103] **Example:** "Upon liquidation or dissolution of the corporation, or winding up of its affairs, before any amount is paid to the holders of the Common Stock, the holders of the Preferred Stock shall receive an amount equal to $_____ per share held plus any accumulated and unpaid dividends thereon." (*For alternative articles provision, see Form 4:A.1f.*)

3) [3:104] **Participation rights:** Unless the articles expressly provide otherwise, preferred stock is *entitled to participate* with the common stock in any distribution from the corporation, after having received its preferred dividend or liquidation distribution. This is because all shares are created equal unless otherwise provided in the articles; i.e., "Except as specified in the articles … *no distinction shall exist* between classes of shares or the holders thereof." [Corps.C. § 203; *¶ 4:46*]

a) [3:105] **Provisions limiting participation rights:** Consequently, if (as is usually the case) the parties intend to *limit* the preferred stock's right to dividends or distributions on liquidation to the amount of the priority distribution, such limitation *must be expressly stated in the articles*.

• [3:106] **Example:** "The holders of the Preferred Stock shall *not* be entitled to participate in dividends or distributions upon liquidation or dissolution of the corporation, other than with respect to their priority dividends and priority liquidation distributions as hereinabove provided." (*For alternative articles provision, see Form 4:A.1f.*)

b) [3:107] **Compare—drafting participation provisions:** If participation rights are desired, there are a number of issues to consider in drafting:

• Whether the preferred's participation rights arise before, or only after, the common shares have received a dividend equal to the preference dividend paid on the preferred.

• Whether the preferred is to participate in the same amount *per share* as the common shareholders (e.g., $10 per share); or is to receive *as a class* the same amount paid to the common stock as a class (so that if there are fewer preferred shareholders, they will end up with more per share than the common stockholders).

• Whether the preferred's participation rights apply to distributions on liquidation of the corporation, as well as to dividends.

FORM: Optional Articles Provisions Establishing Liquidation Preferences (Participation Provision), *see Form 4:A.1f*.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[3:108 - 3:110] ***Reserved.***

c) [3:110.1] **Tax advantage of participation rights:** Preferred stock that participates in distributions *over and above* its stated priority can avoid potential adverse tax consequences associated with "nonqualified preferred stock"; *see ¶ 3:340.2 ff.*

4) [3:111] **Voting rights:** Preferred stock is usually created without voting rights. But, to accomplish this, the articles of incorporation must *specifically deny* voting rights on the preferred. Otherwise, in the absence of such restriction, "all shares are created equal" (see Corps.C. § 203, ¶ 3:104), and the preferred shares would have the same voting rights as the common.

a) [3:112] **Compare—right to approve fundamental changes affecting preferred shares:** Even if created without voting rights, a majority of the preferred shares must approve any *amendment of the articles* or other fundamental change *affecting the preferred shares*; *see ¶ 8:56*.

This requirement *cannot* be eliminated in the articles; nor can the articles authorize approval of such changes by less than a majority of the preferred. [Corps.C. §§ 402.5(a), 903(a)(4); *see ¶ 4:140*]

b) [3:113] **Example:** The following provision is generally used to permit only those voting rights on preferred stock as are required by law: "The holders of the Common Stock shall have exclusive voting rights and powers and the exclusive right to notice of shareholders' meetings, and the preferred shares shall have no vote, except as otherwise provided by law."

c) [3:114] **Voting rights on dividend default:** Even if created without voting rights generally, it is common for the articles to confer full voting rights on the holders of the preferred shares during periods of dividend arrearages or other specified conditions.

1/ [3:115] **Example:** "If four or more quarterly dividends on the Preferred Stock have not been declared and paid, the holders of the Preferred Stock shall thereupon be entitled to vote for and elect a majority of the board of directors, and shall retain such right until all dividends accrued on the Preferred Stock have been paid, at which time the right to elect directors shall revert exclusively to the holders of the Common Stock." (*For alternative articles provision, see Form 4:A.1e*.)

d) [3:116] **Additional voting rights:** The articles may also confer additional voting rights on the preferred. For example, the preferred shareholders may be given the right to approve various corporate acts not otherwise requiring their approval; e.g., merger, sale of assets, dissolution, etc.

In such event, the articles may also provide for approval by more, or even *less*, than a majority of the preferred shares. [Corps.C. §§ 400(a), 402.5(a)] (In contrast, the articles cannot authorize approval of articles amendments or other fundamental changes affecting the preferred shares, by *less* than a majority of the preferred; Corps.C. §§ 402.5(a), 903(a)(4) (¶ 3:112).)

[3:117] ***Reserved.***

[3:118] **Limitation:** The articles may not require more than *two-thirds* approval by the preferred shareholders for *dissolution* of the corporation. [Corps.C. § 402.5(b); *see ¶ 4:143*]

5) [3:119] **Conversion rights:** The articles may also provide holders of preferred stock with the *option* of converting their shares into common stock (or some other security of the corporation; e.g., debentures). Conversion rights may be conferred upon the preferred shareholders individually, or may be conditioned on the vote of a majority of the preferred shares, or the occurrence of some other "triggering" event. [Corps.C. § 403]

a) [3:120] **Purpose:** The purpose of conversion rights is to give the preferred shareholders some right to share in the future potential increase in the value of the corporation. Conversion rights are also an important protection where the preferred stock is subject to *redemption* (call) by the corporation (¶ 3:132). By exercising their rights to convert into common stock, the preferred shareholders can avoid the redemption of their shares.

b) [3:121] **Drafting considerations:** The articles should state:

- Whether the right is ongoing and continuous, or can be exercised only at certain times or on the occurrence of specified events.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Whether conversion is at the option of each individual holder, or only upon vote of a majority of the outstanding preferred shares.

• The precise terms on which the shares can be converted (e.g., the number of shares of common stock into which each share of preferred stock may be converted).
FORM: Optional Articles Provisions Granting Conversion Rights, *see Form 4:A.1h*.

[3:122 - 3:124] ***Reserved.***

c) [3:124.1] **Compare—conversion at *corporation's option:*** A corporation whose stock is listed, at both the time of original issuance and the time of conversion, on the New York Stock Exchange, NYSE American (previously NYSE Amex), Nasdaq Global Market or Nasdaq Capital Market may issue shares convertible *at its option* into any of its other classes of stock or securities, so long as the securities received upon conversion are likewise listed. [Corps.C. §§ 301.5(d), 403(a)(3)]

(c) [3:125] **Protections required by Commissioner of Financial Protection and Innovation:** Unless the preferred share issuance is *exempt* from qualification under the Corporate Securities Law (*see ¶ 5:200 ff.*), the articles should contain the rights and preferences required by the Commissioner of Financial Protection and Innovation (formerly the Commissioner of Business Oversight).

The Commissioner's Rules set forth guidelines for the exercise of the Commissioner's discretion in qualifying issues for sale (particularly for sale to the public … so-called "open permits"). [Commr. Rule 260.140.1-260.140.51]

Where the preferred shares are *not participating* and are *not convertible* "on a *fair and equitable basis*" (per the Commissioner's determination), the rules require that the *articles contain* the following minimum rights and protections:

1) [3:126] **Cumulative dividends:** The articles should state that whatever dividend is payable on the preferred shares is cumulative. [Commr. Rule 260.140.3]

2) [3:127] **Prohibitions on common stock dividends:** The articles should prohibit dividends on the common stock so long as any preferred stock dividend is in arrears; plus "appropriate" other dividend restrictions on the common shares. [Commr. Rule 260.140.3]

3) [3:128] **Voting rights while dividends in arrears:** If the preferred shares do not otherwise have full voting rights, the articles should give them the right to "reasonable representation" on the board if *eight or more* quarterly dividends (whether or not consecutive) are in arrears; such voting rights to continue until the arrears are paid in full. (The right to elect a majority of the board is "presumptively reasonable.") [Commr. Rule 260.140.2]

4) [3:129] **Approval of adverse change:** The articles should also contain an "appropriate" requirement for approval (by vote or written consent) of a specified percentage of the preferred shares for "any adverse change in the rights of such shares"; or for the issue of *new shares* having priority over such shares. [Commr. Rule 260.140.3]

(*Comment:* The Code already provides that an articles amendment changing the rights, preferences, privileges or restrictions of preferred shares requires majority approval of the outstanding shares of the class of preferred so affected, whether or not the articles entitle the class to vote; see Corps.C. § 903(a)(4).)

5) [3:130] **Anti-dilution:** If the preferred shares have *conversion rights* (*see ¶ 3:119 ff.*), the articles should contain provisions protecting against issuance of additional common stock which would dilute the effect of such conversion rights. [Commr. Rule 260.140.6]

(d) [3:131] **Redemption rights:** Subject to the limitations noted below (¶ 3:132 ff.), preferred stock may be made redeemable either at the option of the shareholder or of the corporation. [Corps.C. § 402(a)]

1) [3:132] **Redemption at option of corporation:** The articles may provide that one or more classes of shares shall be redeemable at the option of the corporation. [Corps.C. § 402(a)]

The only limitation is that a corporation cannot issue redeemable *common* shares unless there is another class of common shares outstanding that is *not* redeemable. (But professional corporations are an exception; *see ¶ 2:265*.) [Corps.C. § 402(c)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [3:133] **Purpose:** Redemption provisions enable the corporation to retire shares having priorities and preferences when other sources of financing are available at a lesser cost—e.g., issuing new preferred shares carrying a lower dividend rate, or issuing debt securities at a lower interest rate than the existing preferred stock dividend.

2) [3:134] **Redemption at option of shareholder:** The articles may also provide that preferred shares (but not common shares) be redeemable at the option of the individual shareholders, or upon the vote of a majority of the preferred shares. [Corps.C. § 402(a)]

a) [3:135] **Purpose:** Such a provision gives the preferred shareholders (individually or as a class) a "put" on their shares: i.e., an assurance that they will be able to get out of their investment on the terms specified. (*See ¶ 7:124*.)

3) [3:136] **Drafting considerations:** To be enforceable, the articles must spell out the precise terms and conditions under which the shares can be redeemed; e.g., the price per share, the source of funds to be used for redemption, the time or occasions upon which the corporation may redeem, etc. [Corps.C. § 402(a)]

Also, where redemption of *less* than all outstanding shares is to be authorized ("partial redemptions"), the articles must specify the method of selecting those shares to be redeemed—i.e., pro rata, or by lot, or at the discretion of the board, etc. [Corps.C. § 402(b); *see ¶ 7:112*]

4) [3:137] **Sinking fund provisions:** The articles may also require the corporation to set aside a portion of its earnings for the purpose of accumulating funds for redemption purposes. [See Corps.C. § 402(d); *¶ 7:109*]

5) [3:138] **Compare—exercise of redemption rights dependent on funds available:** Corporate distributions to shareholders are subject to solvency restrictions and other limitations, *discussed at ¶ 7:10 ff.* [Corps.C. § 500 et seq.]

6) [3:138.1] ***Caution—redeemable shares taxable as "boot":*** Redeemable preferred stock that is "nonqualified" may be taxable as "boot" upon incorporation or reorganization. *See ¶ 3:340.1 ff.*

[3:138.2] ***FORM:*** Optional Articles Provisions Granting Redemption Rights, *see Form 4:A.1g*.

(e) Tax-planning considerations re preferred stock

1) [3:139] **No help in avoiding double taxation:** The dividends on preferred stock are *not* deductible by the corporation (unlike interest payments on debt securities). Thus, preferred stock dividends (like dividends on common stock) result in double taxation of the corporation's profits.

2) [3:140] **No S election:** Start-up losses cannot be "passed through" to the shareholders where preferred shares are issued. S corporation status is available only where there is a *single* class of shares outstanding; *see ¶ 2:145*.

3) [3:141] **Section 1244 treatment now available:** However, the special rule allowing shareholders ordinary (rather than capital) loss deductions on sale or worthlessness of their shares in a small business corporation now applies to *preferred* as well as to common stock. [See IRC § 1244(c)(1); *¶ 2:190*]

4) [3:142] **May jeopardize tax-free incorporation:** The issuance of *nonvoting* preferred as payment for assets transferred to the corporation could make the transfer a taxable transaction to the transferors (incorporators). Tax-free treatment is available only where the transferor ends up with at least 80% of the voting power of the corporation (i.e., at least 80% of all classes entitled to vote) *and* 80% of the total number of shares of all *other* classes of stock issued. The issuance of nonvoting preferred may complicate or prevent the transfer from qualifying. [IRC §§ 351 & 368(c); *see ¶ 3:346*]

[3:143] ***Reserved.***

4. [3:144] **Allocating Control of Corporation:** In the absence of other arrangements (¶ 3:145 ff.), a corporation is subject to the control of those holding a majority of its voting shares. While it is true that the directors technically have the power to make all management decisions, they serve at the will of the majority shareholders: i.e., those holding a majority of the voting shares can elect a majority of the directors; and can remove them from office at any time, with or without cause. [Corps.C. §§ 300(a), 303, 152]

There are several devices, however, which may curtail the majority running rough-shod over the minority. As discussed below (¶ 3:145 ff.), the minority shareholders have the statutory right to *cumulate* their votes in electing directors, and this tends to assure minority representation on the board. Moreover, the parties may agree in advance to pooling agreements and other arrangements to assure minority shareholders' participation in (or even *control* of) corporate affairs.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a. [3:145] **Cumulative voting for directors:** California law gives shareholders the right to *cumulate* their votes in electing directors. Shareholders get one vote for each director to be elected, and can then cast their votes all for one director or any other way they choose. [Corps.C. § 708]

The effect is to give minority shareholders holding a significant percentage of the stock representation on the board which they might *not* be entitled to on a "straight" voting basis (one vote per share); *see ¶ 3:150 ff.*

(1) [3:146] **Right exists as matter of law:** The right to vote cumulatively for directors need *not* be specifically provided in the articles or bylaws. It exists as a matter of law. Indeed, except as to "listed" corporations (*see ¶ 3:148*), any provision to the contrary in the articles or bylaws is void as contrary to public policy. [Corps.C. § 708]

(a) [3:147] **No "staggered" terms of office:** Nor can the right be defeated or curtailed by staggering the terms of the directors; i.e., except with respect to certain corporations (*see ¶ 3:148*), *all* directors must be elected at the same time. [Corps.C. § 301]

(b) [3:148] **Exception for "listed" corporations:** Corporations with stock listed on the New York Stock Exchange, NYSE American (previously NYSE Amex), Nasdaq Global Market or Nasdaq Capital Market may, *in their articles or bylaws*, divide the board of directors into classes to establish staggered terms and/or eliminate cumulative voting (*see ¶ 4:77a ff.*). [Corps.C. § 301.5]

1) [3:148.1] **Adverse effect on minority shareholders:** Obviously, eliminating cumulative voting for directors, and/or establishing staggered terms so that not all directors are elected in a given year, greatly diminishes (or eliminates altogether) minority shareholder representation in corporate governance.

(c) [3:148.2] **Exception for statutory close corporations:** A statutory close corporation (*¶ 3:233 ff.*) may dispense with cumulative voting in its shareholders agreement. [Corps.C. § 300(b), (c)]

(d) [3:148.3] **Exception for mutual water companies:** A mutual water company may adopt an article or bylaw provision authorizing the election of directors to serve staggered four-year terms. (Upon the *initial* election of directors to staggered terms, the directors must determine by *lot* who shall serve two vs. four-year terms.) [Corps.C. § 301.9]

[3:148.4] ***Reserved.***

(e) [3:148.5] **Limitation on removal of individual directors:** No individual director, once elected, can be *removed* during that director's term of office if the votes against removal would have been enough to elect the director through cumulative voting. [Corps.C. § 303(a)(1)]

This rule applies even in the case of "listed" corporations that have *eliminated cumulative voting* and whose boards are serving staggered terms (*see ¶ 3:148*). [Corps.C. § 303(a)(3)]

(2) [3:149] **Prerequisites:** However, the right to vote cumulatively is not automatic. The names of the candidates for the board of directors must be placed in nomination prior to the voting; and *at least one shareholder must give notice* at the meeting prior to the voting of the intention to cumulate that shareholder's votes. If any shareholder gives such notice, all shareholders may cumulate their votes. [Corps.C. § 708(b)]

(3) [3:150] **Mechanics:** Each share gets one vote for each director to be elected. Thus, if a shareholder owns 10 voting shares, and there are five directors to be elected, the shareholder has 10 votes for each director, or a total of 50 votes. The shareholder may then "cumulate" these votes—casting them all for any one director, or some for one and some for another, or any other way the shareholder chooses.

(a) [3:151] **Formula:** The following is the formula used in computing the number of shares needed to elect a given number of directors:

• First, the total number of shares which will participate or vote in the election must be multiplied by the number of directors desired to be elected by the minority shareholder;

• Second, the figure so determined must be divided by the number of directors to be elected, *plus one;* and

• Third, the result so obtained must be *increased by one* (or if a fraction, rounded off to the next highest whole number).

(b) [3:152] **Example:** If there are three directors to be elected, and 100 shares voting, to elect one of them, a minority shareholder will need at least *26* shares: 100 x 1 divided by 4 (3 directors plus 1) = 25 plus 1 = 26. Those 26 shares are entitled to 78 votes (3 directors x 26). The other 74 shares would have 222 votes (3 x 74). But even if those 222

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

votes were spread evenly among 3 candidates, each would receive only 74 votes, and thus could not defeat the candidate with 78 votes. (And, of course, if the other shareholders voted more for one or two candidates, they would have fewer votes on the other.)

(c) [3:153] **Shorthand expression of formula:** An abbreviated method of computing the shares needed to elect a director is simply to divide the number of shares voting (100) by 1 more than the number of directors to be elected (1 + 3 = 4), and then add 1 to the figure so obtained (1 + 25 = 26).

[3:153.1] Put another way, to determine the *fraction* or *percentage* of the total vote needed to elect one director, simply make a fraction out of the *total number of directors being elected* (e.g., if 3 directors are to be elected, the fraction is 1/3), and then augment the denominator *by one* (i.e., the fraction becomes 1/(3 + 1) = 1/4). The number of shares needed out of the total shares voting to elect *one* director, expressed as a fraction (or percentage) of the total, is thus 1/4 (25%) *plus one* (*or, rounded upward to the next whole share*). This is illustrated as follows:

number of directors to be elected	**% of shares needed to elect one**
3	1/4+ (25%+)
4	1/5+ (20%+)
5	1/6+ (16-2/3%+)
6	1/7+ (14-2/7%+)
7	1/8+ (12-1/2%+)

➪ [3:154] ***PRACTICE POINTER:*** Sometimes clients propose to issue shares in such percentages that some of the shareholders will not be assured of representation on the board. Use the above formulas (¶ 3:151 ff.) to alert the clients to the potential problems. They may wish to make other arrangements for allocating control.

b. [3:155] **Articles may create several classes of voting shares:** An alternative device for assuring minority shareholders' representation on the board of directors is for the articles to create two or more classes of voting shares, with each such class entitled to elect, *as a class*, one or more directors. [Corps.C. § 301(a)]

• ***FORM:*** Optional Articles Provision Creating "Classified Board," *see Form 4:A.1t*.

(1) [3:156] **Purpose:** The use of multiple classes of voting shares, with each class entitled to elect one or more directors, enables representation on the board of minority shareholders whose interests would be *too small* for representation under cumulative voting. (Note, however, that cumulative voting rights apply to voting *within* each class.)

(2) [3:157] **Example:** Financial considerations indicate capital stock should be issued 1000 shares to X, and 10 shares to Y; but the clients want Y to have the right to elect two of the five directors. Corporation can be authorized to issue *two classes of shares*: Class A common which can elect three directors; and Class B common which can elect two directors. Then it can issue 1000 of the Class A shares to X, and 10 Class B shares to Y. Result: Y can elect two of the directors although he holds less than 1% of the outstanding stock.

(3) [3:157.1] **Limitation on removal of directors:** Directors elected by a particular *class* of shares may be removed *only* by the "applicable vote" of the holders of that *same class* of shares. [Corps.C. § 303(a)(2)]

c. [3:158] **Articles may require greater-than-majority shareholder or director vote:** Another device that can give minority interests influence or control is to provide in the articles that any act requiring shareholder approval must be taken by more than a bare majority—i.e., two-thirds, three-fourths or even unanimous consent may be required. (Limitation: With certain exceptions, a corporation with 100 or more shareholders of record may not amend its articles or file a certificate of determination (¶ 4:45) that requires supermajority approval by more than two-thirds of the outstanding shares; Corps.C. § 710, *see ¶ 4:115.2 ff.*) Similarly, the articles may, subject to certain limitations, require a greater-than-majority vote or quorum for board of director actions. [Corps.C. § 204(a)(5); *see ¶ 4:82, 4:114*]

FORMS

• Optional Articles Provision Requiring Super-Majority Vote of Directors, *see Form 4:A.1m*.

• Optional Articles Provision Requiring Super-Majority Vote of Shareholders, *see Form 4:A.1s*.

d. [3:159] **Shareholders' pooling agreements and voting trusts:** Other devices for allocating control in a manner disproportionate to share ownership are shareholder agreements or voting trusts. These devices enable the parties at the time

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

of forming the corporation to vest voting control in persons who hold only a minority interest (or who may not have *any* shareholdings at all).

(1) [3:159.1] **Shareholder voting agreements ("pooling agreements"):** Two or more shareholders in any corporation (not just close corporations) may agree to "pool" their votes, or to vote in a specified way on specified matters for an agreed period of time. These agreements are used primarily to combine votes for the election of directors, to increase representation on the board; but they may also cover other matters on which shareholders may vote. [Corps.C. § 706(a); see *Ramos v. Estrada* (1992) 8 CA4th 1070, 1075, 10 CR2d 833, 836 (citing former text)]

[3:159.2] ***Reserved.***

(a) [3:159.3] **Enforcement:** If a shareholder refuses to vote their shares as agreed, the remedy is a suit to compel specific performance of the agreement. [Corps.C. § 706(a); see *Ramos v. Estrada* (1992) 8 CA4th 1070, 1077-1078, 10 CR2d 833, 838]

(b) [3:159.4] **"Self-executing" agreements:** The parties may attempt to make their pooling agreements self-executing by giving *irrevocable proxies* to vote their shares in accordance with the agreement. Said proxies may be executed either in favor of one of the shareholders or some other designated person.

1) [3:159.5] **Irrevocable proxies:** Irrevocable proxies are authorized if given by a "person designated by or under an agreement under Section 706." [Corps.C. §§ 705(e)(5), 706(a); *see* ¶ *6:114*]

[3:159.6 - 3:159.7] ***Reserved.***

(2) [3:159.8] **Voting trusts:** This is another device that may be utilized by shareholders to allocate control. Each participating shareholder transfers *legal title* to their shares to a trustee in return for a "voting trust certificate." The certificate evidences the shareholder's equitable ownership of the shares involved, and ordinarily is transferable and carries with it the right to dividends and other distributions from the corporation. However, the right to vote the shares involved is conferred upon the trustee for the life of the trust. [Corps.C. § 706(b)]

➪ [3:159.9] ***PRACTICE POINTER:*** While useful in allocating control in closely-held corporations, voting trusts have a major disadvantage: They tend to deflate the value of the shares involved, since it is usually far more difficult to sell voting trust certificates than to sell the shares outright.

(a) [3:159.10] **Formalities:** A voting trust requires a written agreement. A duplicate of the trust (and of any extension, see ¶ 3:159.11) must be filed with the secretary of the corporation. It must be open to inspection by any shareholder or holder of a voting trust certificate on the same basis as the corporation's shareholder list (*see* ¶ *6:522*). [Corps.C. § 706(b)]

(b) [3:159.11] **Duration:** A voting trust may be created for *up to 10 years*. If created for a longer term, it will nevertheless be valid for 10 years. [Corps.C. § 706(b)]

Any time prior to two years of its expiration, the trust may be extended for up to an additional 10 years by written agreement between any two or more shareholders (and written consent of the trustee). There may be any number of successive extensions. Of course, shareholders who refuse to consent to an extension are not bound; their shares revert to them outright. [Corps.C. § 706(b)]

(c) [3:159.12] **Scope of authority conferred on trustee:** The voting trustee's authority depends on the terms of the trust. In the absence of limitation, the trustee would apparently have power to vote the shares on *all* matters on which shareholder approval is required; e.g., amendment of articles, sale of all assets, even dissolution of the corporation.

➪ [3:159.13] ***PRACTICE POINTER:*** For this reason, it is important to spell out in the voting trust agreement the *procedures* by which the trustee will be authorized to vote. Commonly, the procedure is for the trustee to request written instructions from the holders of the voting trust certificates and to vote the shares accordingly (e.g., as the majority or a greater percentage of the shares directs).

(d) [3:159.14] **Rights of holders of voting trust certificates:** Typically, the voting trust agreement provides that the holders of voting trust certificates normally retain all of their economic rights as shareholders; e.g., to dividends and distributions from the corporation.

In addition, they have the following specific rights:

• To bring shareholders derivative suits (Corps.C. § 800(b));

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- To inspect the corporation's shareholders list and other books and records (Corps.C. §§ 1600(c), 1601);

- To sue for involuntary dissolution of the corporation (Corps.C. § 1800(a), (e)); and

- To purchase other shareholders' shares to avoid dissolution (Corps.C. § 2000(e)).

(e) [3:159.15] **Securities law considerations:** Voting trust certificates are "securities" under both federal and state securities laws. Accordingly, their issuance is subject to the same qualification and registration requirements—and the same exemptions—as any other security. (See "Share Issuance: Securities Law Considerations," *¶ 5:1 ff.*)

1) [3:159.16] **Special exemption for trust certificates reflecting stock split or dividend:** Where shares already held in a voting trust are subject to a stock split or stock dividend that does not itself require qualification under the California Corporate Securities Law (*¶ 7:265 ff.*), the issuance of new voting certificates to reflect the split or dividend will also be exempt from qualification. [Commr. Rule 260.105.9]

- ***FORM:*** Voting Trust Agreement, *see Form 3:A*.

5. [3:160] **Typical Allocations:** The particular mix of equity and debt securities to be issued in any given case depends, of course, upon the objectives and concerns of the particular clients. While these may be infinitely variable, some generalizations are possible for certain typical and recurrent situations.

a. [3:161] **Equal investors who will be equally active:** If the principals will be investing equal amounts of cash (or other assets) and will be more or less equally active in the business, the simplest and probably best arrangement would be a single class of voting common stock, plus a *reasonable* amount of debt.

Utilizing a single class of voting stock makes possible an S election, which may be an important tax objective. And, it is one of several conditions required if the organizers plan to rely on the Corps.C. § 25102(h) exemption, *discussed at ¶ 5:225*.

- [3:162] Consideration should be given to the issuance of *some* debt in exchange for a portion of the cash or other assets being invested, in order to permit the investors to draw out a portion of the corporation's earnings as interest, rather than dividends, to avoid double-taxation. However, to avoid the risk that such shareholder-debt may be reclassified as "equity," it should not be issued in direct proportion to shareholdings; or if so issued, the ratio of debt to equity should not exceed 3 to 1 (*see ¶ 3:50*).
- [3:163] Corporate profits can be distributed to the investors in the form of salaries or other compensation for services rendered, as long as the amounts so distributed do not exceed "reasonable business expenses" (to avoid their being treated as nondeductible dividend distributions; *see ¶ 2:106*).
- [3:164] **Caution:** If there is only a single class of voting shares, the majority will have control in the absence of other arrangements (*¶ 3:144*). If the shares are evenly divided, the investors should consider *buy-out agreements* or other arrangements for avoiding deadlock (*see ¶ 3:187*).

b. [3:165] **Equal investors who will NOT be equally active:** Where the amounts to be invested will be equal, but the level of services to be rendered to the corporation will vary among the investors, the difference in profit participation is normally best handled by salary differentials.

[3:166] Of course, if one or more of the investors does not plan to be active at all in the business, it will be impossible to justify salary distributions to them. In such cases, consideration should be given to issuing them either *debt* securities or *preferred stock*, or some combination thereof. This would be particularly appropriate where the objectives of such investors is to be assured of a return on their investments ahead of the other investors; and where they are not necessarily concerned with having management and control of the enterprise.

[3:167] There are, however, important drawbacks to keep in mind with preferred stock:

- The corporation will be unable to elect S status (*¶ 2:145*);

- Dividends distributed will not be deductible by the corporation (*¶ 2:103*);

- The § 25102(h) exemption from qualification requirements will not be available. (However, the § 25102(f) exemption ordinarily *will* be available for preferred stock; *see ¶ 5:256*.)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

c. [3:168] **Some investors supplying capital, others supplying services:** Quite frequently, one or more initial investors will provide most of the funds and property to the enterprise, while others will provide most of the "know-how" and day-to-day management services. In such cases, the investor supplying the capital usually wants to maximize the tax savings potential, while the party supplying the services is usually primarily concerned with allocation of control and division of profits.

[3:169] Once again, a single class of voting common stock should be utilized if possible. This allows each of the participants their desired pro rata share of voting power and equity participation (and avoids the drawbacks with preferred stock, ¶ 3:167).

[3:170] However, a threshold consideration is that stock *cannot* be issued for *future* services (*see ¶ 3:308*). Thus, if stock is to be issued to the persons running the business, some other arrangements have to be made. Various options to consider:

• [3:171] The cash investor could allocate a portion of the investor's shares to the service-participant (but not so as to lose "control" for purposes of a tax-free incorporation under IRC § 351).

• [3:172] The cash investor could lend the service-participant the necessary funds or arrange for a bank or other third party to do so.

• [3:173] The service-participant could contribute *some* eligible legal consideration, however minimal its value.

This may consist of tangible or intangible property, or even services *previously* rendered to the corporation. The property or services can be valued at any amount the board of directors determines in good faith to be reasonable (*see ¶ 3:318*). But the amount "paid" for *property* must be the same amount per share as that paid by the cash investors; otherwise, it will be treated as a "bargain purchase" by the corporation and *taxable income* to the contributor. And of course, stock received for *services rendered* is income to the service-participant to the extent the stock's value exceeds any amount paid therefor (per IRC § 83; *see ¶ 2:171, 3:333*).

• [3:174] The amount of stock issued could be reduced to an amount as to which the service-participant can afford to pay their proportionate share; with the balance of the cash investment being treated as a loan to the corporation. (The obvious problem here is the *ratio* of stock to loans; if it is excessive, the loans may be reclassified as stock for tax and securities purposes; *see ¶ 3:50*.) Under this agreement, the cash investor can receive a return on their investment in the form of interest, and the service participant can receive a salary—both of which will be deductible by the corporation. Any remaining profit distributions would be in the form of dividends pro rata on the common stock issued to each of them.

• [3:175] The corporation could give the service participant an *option* to purchase shares exercisable upon the completion of specified years of employment or specific services (or the capital investor could agree to sell a portion of their shares on similar terms).

6. [3:176] **Preventing Changes in Control-Financial Structure:** Once the control and financial allocations are agreed upon, the parties may wish to preserve the structure against changes without the consent of all participants. Several devices can be utilized for this purpose:

a. [3:177] **Limits on further issuance of voting stock:** Obviously, the issuance of additional shares of voting stock to some of the original investors or to third parties would dilute the control and equity rights of the original investors. This can be prevented by provisions in the articles of incorporation authorizing only the number of shares to be issued as part of the initial capitalization. The issuance of additional shares would then require *amendment* of the articles of incorporation, and this requires approval by at least a majority of the board of directors and shareholders. [Corps.C. § 903(a); *see ¶ 8:48 ff.*]

(1) [3:178] **Supermajority board approval requirement:** To prevent approval of such amendments by a bare majority of the board of directors, the *articles* could require a greater-than-majority approval by the board. (Or, for that matter, the articles could require such vote for issuance of any shares or incurring any large corporate debt.) [See Corps.C. § 204(a)(5)]

If such provisions are in effect, minority shareholders with enough shares to assure representation on the board are protected against unwanted dilution of their shareholdings.

(2) [3:179] **Supermajority shareholder approval requirement:** Alternatively, the *articles* may provide that amendments increasing the corporation's authorized capital require greater-than-majority *shareholder* approval—e.g., the articles may even require *unanimous* approval by existing shareholders. [Corps.C. § 204(a)(5); *see ¶ 4:114*]

Such a provision will effectively block the creation or issuance of new shares without the consent of *every* minority shareholder. This is particularly suitable to protect those whose interests are too small for representation on the board of

directors. (Limitation: Corporations with 100 or more shareholders generally may not require supermajority approval by more than two-thirds of the outstanding shares; Corps.C. § 710, *see ¶ 4:115.2 ff.*)

➪ [3:179.1] ***PRACTICE POINTER:*** Carefully consider with your client any unanimity requirement for corporate action. Unanimity permits a minority (or even a single director or shareholder) to "hold up" the majority and prevent corporate action … even where the action is considered overwhelmingly attractive by all other directors or shareholders and even where the reason for the "hold up" is vindictive (or "political") and completely unrelated to the action.

b. [3:180] **Preemptive rights:** Where no such limits on future share issuance are desired, the original shareholders can still be protected against dilution of their control and equity rights by including provisions for preemptive rights in the *articles*. Such provisions guarantee current shareholders their right to subscribe to their proportionate share of specified future issuances of shares by the corporation. [Corps.C. § 204(a)(2); *see ¶ 4:108*]

• ***FORM:*** Optional Articles Provisions Granting Preemptive Rights, *see Form 4:A.1j*.

➪ [3:181] ***PRACTICE POINTER:*** Preemptive rights are cumbersome and restrictive when new capital needs to be raised. Consequently, if a *large* number of shareholders is planned, preemptive rights are usually *not* recommended.

7. [3:182] **Providing for Future Changes in Financial Structure:** Often, the parties contemplate (and may even desire) future changes in the financial and control allocations, and these should be taken into consideration at the time of forming the corporation. Here are some typical situations:

a. [3:183] **Stock options to younger participants:** Often, the principal investors intend at some point to transfer more control and/or greater financial interests in the corporation to younger persons who are active in running the business. In such cases, a grant of options to purchase shares either from the corporation or from a majority shareholder, may be desirable.

The exercise of such options may be made *conditional* on the optionee remaining in the employ of the corporation, or the corporation attaining certain goals under the optionee's management. The grant of options from the corporation may have significant tax advantages to the optionee; *see ¶ 2:220*.

b. [3:184] **Employment contracts with buy-back provisions:** Not all service-participants intend to remain with the business indefinitely. Often, they may wish to retain their mobility, in which event they do not want to be stuck indefinitely with non-marketable minority shares. In such cases, good planning dictates an employment contract that assures the other investors in the corporation a minimum service commitment, coupled with a buy-back agreement to insure the service-participants a market for their stock at such time as they may wish to withdraw from the enterprise.

c. [3:185] **Repayment to cash investors:** Similarly, the investors putting up cash may not wish to have their capital tied up indefinitely in the business. They may prefer instead some arrangement for repayment of all or some portion of their investments out of the first profits available. In such cases, either debt (with a fixed maturity) or preferred stock (with sinking fund provisions to facilitate redemption) may be desirable. Either may be coupled with some common stock if the investors are willing to have a portion of their capital remain in the business indefinitely.

[3:186] As between debt and preferred stock, tax planning favors use of debt. Preferred stock would prevent the corporation's filing an S election (passing through its losses, or profits, to the shareholders). Moreover, if nonvoting preferred is issued, there is a risk that the funds used in redemption may be taxable as an ordinary dividend if there are earnings and profits, unless the redemption *completely* terminates the investor's investment in the company. [See IRC §§ 301(c), 316(a); *¶ 7:231*]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 3-C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

C. Buy-Out Agreements

1. [3:188] Purposes
2. [3:189] Events Triggering "Buy-Out"
    - a. [3:190] Death
    - b. [3:191] Attempt to sell
    - c. [3:192] Termination of employment
        - (1) [3:193] Retirement
        - (2) [3:194] Disability
        - (3) [3:195] Expulsion
        - (4) [3:196] Voluntary withdrawal
        - (5) [3:196.5] Effect of termination on employee's rights as shareholder
    - d. [3:197] Bankruptcy
    - e. [3:198] Compare—in professional corporations
3. [3:199] Stock Redemption vs. Cross-Purchase Agreements
    - a. [3:200] Limitations under corporate law
    - b. [3:201.1] Securities law considerations
        - (1) [3:201.2] "Organizational documents" include shareholders agreement
    - c. [3:202] Tax effect—stepped-up basis
    - d. [3:209] Practical considerations
        - (1) [3:210] Number of shareholders
        - (2) [3:211] Financial ability of remaining shareholders
4. [3:216] Funding Buy-Sell Agreement
    - a. [3:217] Accumulated earnings
    - b. [3:221] Insurance
        - (1) [3:222] Policy ownership
        - (2) [3:225] Tax considerations
5. [3:226] Establishing Price
    - a. [3:227] Agreed price, annually updated
    - b. [3:229] Arbitration or appraisal at time of buy-out
    - c. [3:231] Formula price
    - d. [3:231.5] Compare—value for enforcing covenant not to compete
        - (1) [3:231.6] Tax treatment of payor—15-year amortization of covenant amount
    - e. [3:232] Compare—value for estate tax purposes
        - (1) [3:232.1] Application

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

6. [3:232.3] Buy-Out Agreement Superseded by Dissolution Proceedings

[3:187] Shareholders of closely-held corporations often find it desirable to restrict sale or other disposition of their shares, and to provide for purchase of such shares upon death or withdrawal from the business or other specified events. [See *Stephenson v. Drever* (1997) 16 C4th 1167, 1173, 69 CR2d 764, 767 (citing text)]

FORM: Buy-Out Agreement, *see Form 3:B*.

1. [3:188] **Purposes:** Buy-out arrangements in a closely-held corporation can meet the following objectives:

• To prevent unwanted outsiders or inactive heirs from acquiring ownership interests and getting involved in the business affairs;

• To prevent insiders who retire or are no longer active in the business from continuing to hold shares;

• To provide continuing ownership and control in the remaining shareholders;

• To prevent shareholders from selling to other shareholders so as to disturb existing control/financial allocations;

• To provide an assured market for the shares (and thus, liquidity) on a shareholder's death, retirement or withdrawal from the corporation; and

• To establish the shares' value for federal estate tax and gift tax purposes.

2. [3:189] **Events Triggering "Buy-Out":** The parties must decide on which events a buy-out of their shares *may* (optional) or *must* (mandatory) occur. The most common triggering events are:

a. [3:190] **Death:** A buy-sell agreement will almost always provide some protection against a deceased shareholder's stock passing to the decedent's heirs or being sold by the decedent's estate to outsiders. [See *Stephenson v. Drever* (1997) 16 C4th 1167, 1173, 69 CR2d 764, 767 (citing text)] The big issue usually is whether the "buy-out" in such case should be optional or mandatory.

Shareholders who are likely to survive other shareholders usually want the buy-sell agreement to give them the *option* to buy a deceased shareholder's shares (i.e., a right of first refusal), or want the corporation to have the option to redeem said shares.

At the same time, shareholders contemplating estate planning may want to assure a market for their shares (and liquidity for their estate) in the event of death. To accomplish this, they want the buy-sell agreement to provide a *mandatory* buy-out on death; i.e., that the surviving shareholders (or corporation) *must* purchase the decedent's shares.

b. [3:191] **Attempt to sell:** Another triggering event commonly found in buy-sell agreements is a bona fide offer from a third person to buy the shares of one of the existing shareholders.

The buy-sell agreement will usually provide a "right of first refusal" in such cases (i.e., obligating the shareholder to offer the shares first to the corporation or to the other shareholders pro rata, on the same terms and conditions offered by the third person). Or, alternatively, the buy-sell agreement may give the other shareholders an option to buy at a pre-agreed price and terms, to prevent the sale to the third person altogether.

c. [3:192] **Termination of employment:** A shareholder's termination of employment, whether voluntary or involuntary, will also usually trigger a buy-out. [See *Stephenson v. Drever* (1997) 16 C4th 1167, 1173, 69 CR2d 764, 767 (citing text)] The agreement must specify whether the buy-out is mandatory or optional; and, if optional, who has the option—i.e., the corporation, the remaining shareholders, or the withdrawing employee (to "put" the shares to the corporation).

(1) [3:193] **Retirement:** The agreement may provide that shareholders who are active in the business may (or shall) retire at a specified age, and have their interest purchased by the corporation or remaining shareholders. The buy-out is often made mandatory in such cases, in order to assure funds for retirement, etc.

(2) [3:194] **Disability:** Similarly, the agreement may provide for the purchase of shares of any shareholder who has been active in the business and is unable to continue because of illness or injury. The buy-out in such event may either be at the option of the disabled shareholder, or the corporation (or other shareholders), or both.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

The agreement should define clearly what constitutes "disability"—i.e., permanent vs. temporary disability; partial vs. total disability, etc. Often, the agreement will provide that absence or inability to work full time for a certain number of weeks or months during a year shall constitute the triggering event.

(3) [3:195] **Expulsion:** The involuntary termination of a shareholder's employment in the business may also trigger a buy-out. In this situation, *reciprocal* buy-out rights are commonly provided: i.e., both the expelled shareholder and the remaining shareholders (or corporation) are usually given the option to sell (or buy) each other's shares.

(4) [3:196] **Voluntary withdrawal:** Where shareholder-employees voluntarily terminate their employment, the corporation or remaining shareholders are usually given an *option* to purchase the shares of the withdrawing shareholders. But the withdrawing shareholder usually cannot force the others to buy the shareholder out (i.e., the buy-out is optional, not mandatory).

[3:196.1 - 3:196.4] ***Reserved.***

(5) [3:196.5] **Effect of termination on employee's rights as shareholder:** The general rule is that a shareholder whose stock is the subject of a pending (i.e., "executory") contract to sell retains all shareholder rights until the contract is performed and the shareholder parts with title to the stock. [*Stephenson v. Drever* (1997) 16 C4th 1167, 1173-1174, 69 CR2d 764, 767; see *Gilfallan v. Gilfallan* (1914) 168 C 23, 31, 141 P 623, 626]

This rule applies where the shareholder is an employee whose stock is subject to *mandatory* buy-out upon termination of employment. *Unless the agreement expressly provides otherwise* (e.g., that employee's rights and status as shareholder cease upon termination of employment), the terminated employee continues to have all the rights of a shareholder (right to vote, participate in corporate distributions, receive information regarding the corporation, etc.) during the buy-out process. Also, where the employee is a minority shareholder (as is frequently the case), the controlling shareholders continue to have *fiduciary duties* to exercise control fairly and in good faith for the benefit of *all* shareholders (*¶ 6:335 ff.*), including the employee so long as the employee retains shareholder status. [*Stephenson v. Drever*, supra, 16 C4th at 1174-1175, 69 CR2d at 768 & fn. 5]

➪ [3:196.6] ***PRACTICE POINTER:*** A provision in the agreement stating that an employee's rights as a shareholder *cease immediately upon termination of employment* will prevent a former employee from using their shareholder rights to disrupt corporate operations. (But bear in mind that if the employee's rights as a shareholder cease upon termination of employment, the employee is then entitled to payment for the value of their shares on the terms set forth in the contract —the shareholder becomes a creditor of the corporation.) [See *Stephenson v. Drever* (1997) 16 C4th 1167, 1174-1175, 69 CR2d 764, 768]

Of course, the employee would be concerned that the other shareholders might "loot" the corporation following the employee's termination (e.g., strip the corporation of assets by declaring an extraordinary dividend or increasing their salaries). But this concern can be assuaged: Where the agreement provides for buy-out at an agreed price (¶ 3:227) or at a price determined as of the date of termination (*see ¶ 3:229 ff.*), and the corporation and other shareholders covenant not to take any act to jeopardize payment of the purchase price, subsequent events become largely irrelevant.

d. [3:197] **Bankruptcy:** Again, to prevent strangers from becoming shareholders, the bankruptcy (or assignment for benefit of creditors, etc.) of any shareholder may trigger buyout rights in the corporation or other shareholders.

e. [3:198] **Compare—in professional corporations:** Buy-sell agreements take on special importance in professional corporations because only licensed professionals are permitted to own the shares (*see ¶ 2:262*).

Events that might trigger an optional buy-out in other corporations usually trigger a *mandatory* buy-out in a professional corporation. For example, on death or disqualification of a shareholder-professional, the remaining shareholder-professionals (or the corporation) are usually obligated to purchase the shares. Failure to do so results in loss of professional corporation status (*see ¶ 2:261*).

3. [3:199] **Stock Redemption vs. Cross-Purchase Agreements:** The two methods of buying out a deceased, retired, terminated or disabled shareholder are by corporate repurchase (redemption), or purchase by the other shareholders (cross-purchase agreements).

Often, a buy-sell agreement combines *both* forms of buy-out: i.e., the corporation is given the first option to repurchase; but if for any reason it is unable or fails to do so, then the other shareholders have the option to purchase.

Whether repurchase is to be by the corporation or by the other shareholders involves significant legal, tax and practical considerations:

a. [3:200] **Limitations under corporate law:** There are statutory limitations on corporate dividends and distributions to shareholders—insolvency, impairment of dividend priorities, etc. (Corps.C. §§ 500-503; *see* *¶ 7:10 ff.*). These limitations apply to redemption or repurchase of shares by the corporation; but not to cross-purchase agreements with other shareholders.

Thus, if the parties want the corporation to reacquire the shares, it will have to have sufficient retained earnings or excess net worth to meet the statutory limitations on corporate distributions to shareholders (*¶ 7:10*).

➪ [3:201] ***PRACTICE POINTER:*** To assure that the corporation will have sufficient assets to meet these statutory limitations, the other shareholders can *guarantee* the corporation's performance of its repurchase agreement. I.e., a provision can be included in the buy-sell agreement obligating the remaining shareholders to contribute additional capital (e.g., by purchasing additional shares from the corporation) to increase the corporation's net worth to the statutory minimum required to effect the redemption or repurchase.

Or, as an *alternative*, the remaining shareholders could agree to purchase any shares that the corporation is unable to redeem or repurchase because of the statutory restrictions. (Their purchase can either be in proportion to their existing holdings, or on some other specified basis.)

b. [3:201.1] **Securities law considerations:** If buy-out provisions are included in the corporation's "organizational documents" (*see* *¶ 3:201.2*), a subsequent modification may be a "change" in the attributes of outstanding shares, constituting a sale of securities and requiring qualification under the Corporate Securities Law (unless otherwise exempt). [See Corps.C. §§ 25017, 25103(e)(11); *¶ 8:83*]

(1) [3:201.2] **"Organizational documents" include shareholders agreement:** The term "organizational documents" is not defined for purposes of Corps.C. § 25103(e)(11). With respect to corporations, the term is generally understood to refer to the articles and bylaws. However, the Commissioner's Rules define "charter documents" to include *shareholders agreements*. [See Commr.Rule 260.001(a), (h)]

Accordingly, if an amendment is proposed to buy-sell provisions contained in any of the articles, bylaws *or shareholders agreement*, the amendment will have to be qualified unless otherwise exempt.

c. [3:202] **Tax effect—stepped-up basis:** A cross-purchase buy-out enjoys a significant tax advantage over a redemption: The remaining shareholders receive a stepped-up cost basis for the shares purchased from the terminating shareholder. This will lower their capital gains when they subsequently sell their shares or the corporation is liquidated (*see* *¶ 2:181*). [IRC § 1012]

In contrast, a redemption of the shares by the corporation does not affect the other shareholders' basis on their stock—even though it may increase the value of those shares.

[3:203 - 3:208] ***Reserved.***

d. [3:209] **Practical considerations:** Although a cross-purchase plan enjoys a tax advantage (¶ 3:202), there may be offsetting disadvantages:

(1) [3:210] **Number of shareholders:** The greater the number of shareholders, the more unwieldy a cross-purchase plan becomes. If there are more than 4 or 5 remaining shareholders, it may be difficult to arrange a buy-out that will leave their proportionate interests intact. In contrast, a stock redemption by the corporation involves only one obligor-purchaser, and the ownership interests of the remaining shareholders are not affected.

(2) [3:211] **Financial ability of remaining shareholders:** Cross-purchase agreements often impose an uneven financial burden on the remaining shareholders because of differences in age, stock ownership and compensation levels. Often, one or more will default, imposing a greater burden on the others, and resulting in shifting the proportionate ownership interests.

[3:212 - 3:215] ***Reserved.***

4. [3:216] **Funding Buy-Sell Agreement:** Obviously, an important aspect of buy-sell planning is to assure that sufficient funds will be available to make the purchase of stock called for under the agreement. The principal sources generally considered are:

a. [3:217] **Accumulated earnings:** Where the agreement contemplates a stock redemption by the corporation, the corporation will have to have accumulated earnings available for this purpose.

However, there are two potential difficulties with relying on accumulated earnings to fund a buy-out:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• [3:218] If the corporation accumulates earnings for the purpose of funding a buy-out, it risks the penalty tax on accumulated earnings (IRC § 531, ¶ *2:113*).

• [3:219] If there are not enough earnings to meet the statutory requirements for corporate distributions (Corps.C. § 500, ¶ *7:10 ff.*), the corporation cannot lawfully perform the buy-sell agreement.

➪ [3:220] ***PRACTICE POINTER:*** To avoid this problem, consider the possibility of an *installment purchase*, spreading the payments over several years, during which additional future earnings could be accumulated.

b. [3:221] **Insurance:** Insurance is often used to fund a buy-out on the death or disability of a shareholder. Moreover, insurance policies on the life of a terminating shareholder may play a role in funding a buy-out triggered by the shareholder's retirement, withdrawal, incompetency, etc.: Any accrued cash surrender values can provide funds for such buy-out. [See Corps.C. § 503]

(1) [3:222] **Policy ownership:** Under a corporate buy-out plan, the corporation will generally pay the premiums and own the policy on the life of each shareholder (and appropriate disability policies as well), to provide the funds necessary for the redemption or repurchase.

[3:223] Under a cross-purchase buy-out plan, each shareholder owns a policy of insurance on the life of every other shareholder—which gets unwieldy where there are numerous shareholders.

➪ [3:224] ***PRACTICE POINTER:*** One alternative is for the shareholders to create a *trust* to purchase and own an insurance policy on the life of each of them. The trustee would be instructed to collect the insurance proceeds on the death of any shareholder and use them to purchase the decedent's stock and distribute the stock pro rata to the surviving shareholders.

(2) [3:225] **Tax considerations:** Premiums paid on life or disability insurance to fund a buy-out are *not* deductible by either the corporation under a stock redemption plan, or by the shareholders (or their trust) in a cross-purchase plan. [IRC § 264(a)(1)]

Conversely, the proceeds of such insurance policies are generally not taxable income to the beneficiaries (either the corporation or remaining shareholders). [IRC § 101(a)]

[3:225.1 - 3:225.4] ***Reserved.***

➪ [3:225.5] ***PRACTICE POINTER—"HYBRID" BUY-OUT PLAN*****:** A combination of redemption and cross-purchase may best achieve the clients' objectives. Where the corporation lacks sufficient assets to redeem the shares of a terminating shareholder, the agreement can obligate the remaining shareholders to purchase whatever shares the corporation could not legally repurchase (under Corps.C. §§ 500-503, ¶ *3:200*). This would be especially desirable if the shareholders have only limited personal funds available, and want the corporate assets to be used to the greatest extent possible in order to reduce their personal obligations.

5. [3:226] **Establishing Price:** To be enforceable, the buy-sell agreement must establish the price at which the shares are to be sold. This can be done in several ways:

a. [3:227] **Agreed price, annually updated:** A frequent method is for the shareholders to agree on the price when they enter into the agreement, and agree to revise it periodically (e.g., annually) thereafter to reflect changed values.

➪ [3:228] ***PRACTICE POINTER:*** The problem with this approach is that the shareholders often fail to reach further agreement, in which event one side or the other is stuck with an outdated value when the buy-out is triggered. (To avoid this, the agreement should provide an alternative method for valuation if the shareholders fail to update the price annually—e.g., shares to be valued at their net book value as of the end of the quarter preceding the buy-out trigger date.)

b. [3:229] **Arbitration or appraisal at time of buy-out:** Another approach is to leave the price open to negotiation at the time of the buy-out, with provision that if the parties are unable to agree, then the price is to be determined by arbitration or appraisal by an independent third party.

➪ [3:230] ***PRACTICE POINTER:*** When this approach is used, the buy-sell agreement should state the *factors to be considered in valuing the shares* at the time of such arbitration or appraisal: e.g., whether the corporation's value is to be determined by capitalizing its earnings (and if so, the appropriate capitalization rate), or by replacement cost of its assets, or on some other basis; and any other factors which the shareholders feel appropriate to determine a fair valuation of their holdings.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

c. [3:231] **Formula price:** Rather than leaving the matter to future agreement or determination by third parties, the buy-sell agreement may provide a formula for determining the price.

For example, the corporation can be valued at some multiple (e.g., 10 times) its average annual net income over the past 3 years; with "net income" defined by generally accepted accounting principles. Or, value can be based on a percentage of gross sales; or on book value, adjusted to current fair market value, plus a specified value for goodwill.

[3:231.1 - 3:231.4] ***Reserved.***

d. [3:231.5] **Compare—value for enforcing covenant not to compete:** As part of the buy-out, the agreement may contain a covenant not to compete. Noncompetition agreements are enforceable against a bought-out shareholder only if the buy-out price compensates for corporate *goodwill*—i.e., the shareholder had a "substantial interest in the corporation" and is *completely* bought out. A buy-out of a small percentage of the corporation's shares that ignores existing goodwill may not support a noncompetition clause. [See Bus. & Prof.C. § 16601; *Hill Med. Corp. v. Wycoff* (2001) 86 CA4th 895, 903-906, 103 CR2d 779, 786-789; *and* ¶ *6:401.2 ff.*]

(1) [3:231.6] **Tax treatment of payor—15-year amortization of covenant amount:** When determining the deductibility of amounts paid for the covenant not to compete, it is irrelevant whether the bought-out shareholder had a "substantial interest" in the corporation. The amount or amounts paid for the covenant must be amortized over a 15-year period *regardless of the size of the bought-out shareholder's interest* in the corporation and *regardless of the term or life of the covenant*. [IRC § 197(a),(d)(1)(E); see *Recovery Group, Inc. v. Commr.*, TC Memo 2010-76, aff'd (1st Cir. 2011) 652 F3d 122—payment to former 23% shareholder for covenant not to compete for one year following buyout amortized over 15 years]

e. [3:232] **Compare—value for estate tax purposes:** One of the important purposes served by a buy-sell agreement is to fix the value of the shares for federal estate tax purposes. A buy-sell agreement will be respected for federal estate tax purposes if:

- It is a bona fide business arrangement;
- It is not a device to transfer the shares to members of the decedent's family for less than full and adequate consideration in money or money's worth; *and*
- Its terms are comparable to similar arrangements entered into by persons in an arms'-length transaction. [IRC § 2703(b); Treas.Reg. §§ 20.2031-2(h), 25.2703-1]

(1) [3:232.1] **Application:** Agreements between a shareholder and a purchaser who is "the natural object of his bounty" are carefully scrutinized to determine that the price reflects a business judgment, rather than merely a device to fix a low estate tax value. [*St. Louis County Bank v. United States* (8th Cir. 1982) 674 F2d 1207, 1210; Treas.Reg. § 20.2031-2(h)]

"Backstop price agreements" (providing a different price mechanism if the contract price is not accepted by the IRS) are particularly risky. They tend to show that the parties were *not* bound by the original agreement. [*Estate of Dickinson v. Commr*. (1975) 63 TC 771, acq. 1977-2 CB 1]

➪ [3:232.2] ***PRACTICE POINTER:*** The safest course is to build a record showing that the price set forth in the buy-sell agreement equals the fair market value of the stock. To do this, the parties should include data showing values at the time the agreement was executed, and update the price periodically to reflect changes in these values.

6. [3:232.3] **Buy-Out Agreement Superseded by Dissolution Proceedings:** Unless provided otherwise in the *articles* (or in a *separate written agreement* between two or more shareholders pertaining to the purchase of shares and referred to in the articles), buy-out arrangements and valuation procedures in a buy-out agreement may be superseded by the statutory buy-back and valuation procedures mandated in suits for involuntary dissolution and in voluntary dissolutions initiated by 50% shareholders (i.e., where the corporation, or 50% shareholders desiring to avoid dissolution, buy out disgruntled shareholders). [Corps.C. § 2000; *see* ¶ *8:773, 8:861*]

➪ [3:232.4] ***PRACTICE POINTER:*** If the shareholders want their buy-out agreement to govern even in the event of dissolution, be sure to include a provision to that effect in the articles. If the provision is set forth in a separate shareholders agreement, be sure that the articles contain a reference to the agreement.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- ***FORM:*** Optional Articles Provision Establishing Primacy of Buy-Out Agreement Upon Dissolution, *see Form 4:A.1v*.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 3-D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

D. Deciding Whether to Be a Statutory Close Corporation

- 1. [3:234] Background
- 2. [3:235] Requirements for Close Corporation Status
  - a. [3:236] Number of shareholders
    - (1) [3:237] Business association as shareholder
  - b. [3:238] Contents of articles
    - (1) [3:239] Amendment of articles of existing corporation
    - (2) [3:240] Compare—termination of close corporation status
  - c. [3:241] Share certificate legend requirement
    - (1) [3:242] Consequences of failure to include legend
    - (2) [3:242.1] Compare—legend requirement on close social purpose corporation shares
    - (3) [3:242.2] Compare—legend requirement on benefit corporation shares
- 3. [3:243] Shareholders agreement
  - a. [3:243.1] Agreement may substitute for optional articles provisions
  - b. [3:244] Filing with corporate secretary
- 4. [3:245] Advantages of Close Corporation
  - a. [3:246] Lack of formalities not basis for alter ego liability
    - (1) [3:247] Of course, this does not…
  - b. [3:248] Validates shareholder agreements as to matters otherwise subject to board approval
    - (1) [3:249] Bypassing board of directors allowed
    - (2) [3:252] Caution—managerial liability
    - (3) [3:253] Limitations on shareholders agreements
  - c. [3:262] Facilitates control by persons holding less than majority of shares
    - (1) [3:263] Compare—other corporations
  - d. [3:264] Facilitates profit-splits disproportionate to share ownership
    - (1) [3:265] Compare—other corporations
  - e. [3:266] Transferees bound by shareholders agreement
    - (1) [3:267] Transferee as party to agreement
    - (2) [3:268] Compare—issuance of new shares
- 5. [3:269] Potential Disadvantages of Close Corporations
  - a. [3:270] Restriction on number of present or future shareholders
  - b. [3:271] Restrictions on transferability of shares
    - (1) [3:272] Limited marketability for such shares
    - (2) [3:273] Compare—transfer on death

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

c. [3:275] Relative importance of corporate formalities
(1) [3:276] As required by shareholders agreement
(a) [3:277] Comment
(2) [3:278] As required for business purposes
(3) [3:279] As required for tax purposes
d. [3:280] Shareholders usually required to guarantee bank loans
e. [3:282] Potential personal liability for managerial decisions
(1) [3:283] Which shareholders?
(2) [3:284] What acts?
(3) [3:285] What limits on liability?
f. [3:289] Potential tax problems
(1) [3:290] Disqualification from S election
(2) [3:291] Costs not deductible
(3) [3:292] Liquidation distributions taxable as ordinary income
g. [3:293] Potential problems under securities law
(1) [3:293.1] Permit needed to adopt agreement?
(2) [3:293.2] Potential exemptions from qualification
(a) [3:294] Disqualification for § 25102(h) exemption
(b) [3:295] Compare—§ 25102(f) exemption still available
h. [3:296] Potential problems and costs in drafting shareholders agreement
6. [3:297] Terminating Close Corporation Status
a. [3:298] By amendment of articles of incorporation
(1) [3:298.1] Corporate approval requirement
(2) [3:299] Prior agreement to amend
b. [3:300] By transfers increasing number of shareholders
(1) [3:301] Disqualifying transfers
(2) [3:304] Articles must be amended
c. [3:305] By issuing shares to new shareholder

[3:233] Before incorporating, consideration should be given to whether the corporation can, and should, elect to incorporate as a statutory close corporation. If the applicable requirements are met, close corporation status may enable the participants to conduct the business more flexibly and informally than is permitted with other corporations.

1. [3:234] **Background:** Close corporations are authorized by statutory provisions enacted in 1975. These statutes recognize that participants in small corporations often reach agreements among themselves as to control and financial matters that are akin to a partnership, and that do not fit within normal corporate procedures (e.g., operating through shareholders' and directors' meetings). The intent of the law is to give effect to such agreements, as long as certain statutory requirements are met. The effect is to allow the participants the benefit of corporate status, and at the same time avoid some of the normal corporate procedures and formalities. [See *Hecht v. Sup.Ct.* (1987) 192 CA3d 560, 565, 237 CR 528, 531 (citing text)]

2. [3:235] **Requirements for Close Corporation Status:** In addition to the normal requirements for incorporation (*see ¶ 4:1 ff.*), the Code requires the following to attain close corporation status:

a. [3:236] **Number of shareholders:** There may be *no more than 35* shareholders of record of all classes of shares outstanding. (Spouses count as one; as do trustees and representatives of a deceased shareholder.) [Corps.C. § 158(a), (d)]

(1) [3:237] **Business association as shareholder:** A corporation, trust, partnership or other business association is counted as a single shareholder, unless the primary purpose of such entity was to acquire the close corporation's shares. In that event, each of its beneficially-interested holders is counted as a separate shareholder. [Corps.C. § 158(d)]

b. [3:238] **Contents of articles:** The articles of incorporation must contain: (a) a provision that all of the corporation's issued shares of all classes shall be held of record by not more than a specified number of persons, not exceeding 35; and (b) a statement "This corporation is a close corporation." [Corps.C. § 158(a)]

(1) [3:239] **Amendment of articles of existing corporation:** Existing corporations may convert to close corporation status by amending their articles to include these provisions. But in such cases, the amendment must be approved by *all* of the existing shareholders. [Corps.C. § 158(b); *see* ¶ *8:61*]

(2) [3:240] **Compare—termination of close corporation status:** Similarly, a statutory close corporation can convert to regular corporation status by an amendment *deleting* these provisions. Here, however, approval by at least *two-thirds* of the shares of each outstanding class is required (the articles may even authorize a simple majority of the shares of each outstanding class). [Corps.C. § 158(c); ¶ 8:62]

c. [3:241] **Share certificate legend requirement:** In addition, the *face* of each share certificate must bear the following "conspicuous" legend:

"This corporation is a close corporation. The number of holders of record … cannot exceed ___ [a number not in excess of 35]. Any attempted voluntary inter vivos transfer which would violate this requirement is void. Refer to the articles, bylaws and any agreements on file with the secretary of the corporation for further restrictions." [Corps.C. § 418(c)]

(1) [3:242] **Consequences of failure to include legend:** If the above statement (¶ 3:241) does *not* appear on the *face* of the share certificate and there is a transfer resulting in the corporation having more than 35 shareholders of record, the corporation *automatically* loses its status as a close corporation. [Corps.C. § 158(e)]

(2) [3:242.1] **Compare—legend requirement on close social purpose corporation shares:** *See* ¶ *9:62*.

(3) [3:242.2] **Compare—legend requirement on benefit corporation shares:** *See* ¶ *9:540*.

3. [3:243] **Shareholders agreement:** The primary vehicle for relaxing corporate formalities and operating the close corporation in accordance with the shareholders' wishes is the shareholders agreement. Subject to limited exceptions (*see* ¶ *3:253 ff.*), the shareholders agreement can modify the normal rules applicable to the management of the corporation, the division of its profits, and the distribution of its assets in liquidation. To qualify as a shareholders agreement for this purpose, the agreement must be a *written* agreement among *all* the shareholders. (If there is only *one* shareholder, the agreement must be between the shareholder and the *corporation*). [Corps.C. §§ 186, 300(b)]

a. [3:243.1] **Agreement may substitute for optional articles provisions:** The close corporation shareholders agreement may validly provide for *any* of the various optional matters that must otherwise be included in the articles to be effective (*see* ¶ *4:61 ff.*). [Corps.C. § 204(a) (last para.)]

b. [3:244] **Filing with corporate secretary:** The shareholders agreement should be filed with the secretary of the corporation for inspection by any prospective share purchaser: A purchaser (or other transferee) who has *actual knowledge* of the agreement—or *notice* thereof by *notation on the share certificate*—is *bound* by its provisions. [Corps.C. § 300(b)]

• ***FORM:*** Close Corporation Shareholders Agreement, *see Form 3:C*.

4. [3:245] **Advantages of Close Corporation:** The particular advantage of incorporating as a statutory close corporation is to confer upon the shareholders much greater power and flexibility in managing the business. If the applicable requirements (¶ 3:235 ff.) are met, the shareholders can function pretty much as *owners* of the business—like partners.

a. [3:246] **Lack of formalities not basis for alter ego liability:** In other corporations, the failure to observe corporate procedures and formalities (e.g., re holding meetings of shareholders and board of directors) is a factor that may result in the principals being held personally liable for the debts of the corporation (*see* ¶ *2:50 ff.*). But the failure to observe such formalities in a close corporation *cannot be considered* as tending to establish shareholder liability for corporate debts. [Corps.C. § 300(e)]

(1) [3:247] Of course, this does not immunize the shareholders from personal liability if there are *other* grounds for "piercing" the corporate veil; e.g., inadequate capitalization; failure to issue capital stock, etc. (*see* ¶ *2:53 ff.*).

b. [3:248] **Validates shareholder agreements as to matters otherwise subject to board approval:** By unanimous, written agreement (*see* ¶ *3:243*), the shareholders of a statutory close corporation can simply *bypass* the board of directors. Their agreement may relate to *any phase of corporate affairs*—including such matters as election of officers, payment of salaries, distribution of dividends, etc. [Corps.C. § 300(b)]

(1) [3:249] **Bypassing board of directors allowed:** In other corporations, such agreements would probably be invalid because such matters normally rest within the exclusive discretion of the board of directors (*see* ¶ *6:173*). But in a close corporation, such agreements are *not* subject to attack on the ground that they "interfere with the discretion of the board

or that it is an attempt to treat the corporation as if it were a partnership or to arrange their relationships in a manner that would be appropriate only between partners." [Corps.C. § 300(b)]

[3:250] Indeed, a board of directors is not even necessary in a statutory close corporation. The shareholders agreement can *dispense with the board of directors entirely* and authorize the shareholders themselves to adopt bylaws, elect officers and do whatever else directors do.

➪ [3:251] ***PRACTICE POINTER:*** However, as a practical matter, this rarely works out. Third parties dealing with the corporation often insist on certified copies of the directors' and shareholders' resolutions to establish the authority of corporate officers. (E.g., bank signature cards must show action by the board of directors authorizing designated corporate officers to sign checks, borrow money, etc.)

(2) [3:252] **Caution—managerial liability:** To the extent that the shareholders agreement authorizes the shareholders to assume managerial responsibility, they also assume managerial liabilities. Thus, the shareholders become *personally liable* for acts or omissions which otherwise would be the responsibility of the directors; and the directors are relieved from liability to the same extent. [Corps.C. § 300(d); *see ¶ 3:282*]

(3) [3:253] **Limitations on shareholders agreements:** While shareholders agreements may generally relate to "any phase of corporate affairs," there are a few statutory exceptions. These are matters strongly supported by public policy and therefore *cannot* be changed even by agreement among all the shareholders: [Corps.C. § 300(c)]

- [3:254] Conditions under which dividends may *not* be paid to shareholders (Corps.C. §§ 500, 501).
- [3:255] Requirements re record-keeping and reports (Corps.C. § 1500 et seq.). (Even so, the requirement of an annual report can be waived in the *bylaws;* see Corps.C. § 1501(a)(1), ¶ *4:389*.)
- [3:256] Right to inspection of corporate records (Corps.C. § 1600 et seq.).
- [3:257] Provisions re involuntary dissolution (Corps.C. § 1800 et seq.).
- [3:258] Criminal penalties for violating applicable laws (Corps.C. § 2200 et seq.).
- [3:259] Statutory requirements specifically applicable to close corporations (Corps.C. §§ 158, 417, 418, 1111, 1201(e)).

[3:260 - 3:261] ***Reserved.***

c. [3:262] **Facilitates control by persons holding less than majority of shares:** In running a new business, it is often desirable to give one or more of the service-participants greater voting and management power than represented by the participant's shareholdings. (For example, the deal may be that X is to run the business without interference by any of the other shareholders, even though X has only 10% of the shares.) The shareholders agreement may vest full management or other powers in persons who hold less than a majority of the shares, or indeed, who may not even be shareholders at all.

(1) [3:263] **Compare—other corporations:** In other corporations, there are also devices for vesting control in persons other than majority shareholders. But such devices are usually complex and cumbersome; e.g., voting trusts and pooling agreements; or several classes of stock, with one class being empowered to elect more directors than the others (*see ¶ 3:155 ff.*).

d. [3:264] **Facilitates profit-splits disproportionate to share ownership:** Similarly, by their agreement, the shareholders of a close corporation may allocate and divide the corporation's profits disproportionate to share ownership (see Corps.C. § 300(b)). This again is often utilized in a new business where it is desired to give the service-participants financial incentives. The shareholders can simply agree that certain shareholders are to be entitled to dividend distributions before others, or in greater amounts, etc.

➪ [3:264.1] ***PRACTICE POINTER:*** Profits allocated to shareholder/employees disproportionately to their ownership interests may be taxable as compensation for *services* (*see ¶ 3:292*).

(1) [3:265] **Compare—other corporations:** Again, there are devices for disproportionate allocation of profits in other corporations; but they are far more complex: e.g., multiple classes of stock with preferential rights, etc. (¶ *3:90*).

e. [3:266] **Transferees bound by shareholders agreement:** As long as the share certificates contain the required notice of close corporation status (¶ 3:241), any transferee of the shares is bound by the shareholders agreement on file with the secretary of the corporation. The notice on the share certificate imparts at least constructive knowledge of the terms of the shareholders agreement, so that the transferee is deemed to have accepted its terms. [Corps.C. § 300(b)]

(1) [3:267] **Transferee as party to agreement:** After such transfer, the transferee (rather than the transferor) is deemed a party to the shareholders agreement. Thus, the transferee's consent will usually be required to any changes; and if

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

managerial liability is imposed (*see* ¶ *3:252*), the transferee can be held *personally* liable along with the other shareholders. [Corps.C. § 300(d)]

(2) [3:268] **Compare—issuance of new shares:** The result is different where a close corporation *issues* shares to a *new shareholder* who refuses to accept the terms of the existing shareholders agreement. In such a case, the *agreement automatically terminates*. [Corps.C. § 300(b)]

5. [3:269] **Potential Disadvantages of Close Corporations:** Notwithstanding the flexibility and advantages described above (¶ 3:245 ff.), there may be offsetting factors to consider:

a. [3:270] **Restriction on number of present or future shareholders:** If the organizers plan initially or in the near future to have more than 35 shareholders of record, the corporation will not qualify for close corporation status. Moreover, if a later stock issuance is planned, the new shareholders will not be bound by the original shareholders agreement (*see* ¶ *3:268*).

b. [3:271] **Restrictions on transferability of shares:** By accepting shares in a close corporation, the original issuee and any transferee are deemed to agree not to transfer the shares so as to increase the number of shareholders above that allowed in the articles (which may not exceed 35). Indeed, as long as the requisite legend appears on the face of the share certificates, any attempted inter vivos transfer would be void. [Corps.C. §§ 421, 418(d); see also Corps.C. § 2800(e) (SPCs)]

(1) [3:272] **Limited marketability for such shares:** The effect is that shares in a close corporation have limited marketability. The holders specifically *waive* any right to register their shares for sale to the public. [Corps.C. § 421]

(2) [3:273] **Compare—transfer on death:** The restrictions on transfer above (¶ 3:271) apply only to voluntary inter vivos transfers. If a shareholder of a close corporation dies, the decedent's shares may be transferred to any number of heirs or beneficiaries. If this increases the number of shares beyond the limit provided in the articles, close corporation status automatically *terminates*. [Corps.C. § 158(e)]

➪ [3:274] ***PRACTICE POINTER:*** To avoid this, the shareholders agreement should include buy-sell provisions upon the death of any shareholder. If such provisions are in effect, the executors or representatives of the deceased shareholder may be compelled to sell the shares to the remaining shareholders (or the corporation), and this will avoid termination of close corporation status.

c. [3:275] **Relative importance of corporate formalities:** While failure to observe normal corporate procedures and formalities will not expose the shareholders to "alter ego" liability (*see* ¶ *3:246*), there are limits on just how informal the operation of a close corporation may be:

(1) [3:276] **As required by shareholders agreement:** First of all, shareholders' and directors' meetings and other corporate formalities can be dispensed with *only to the extent specifically authorized* in the shareholders agreement … and in the corporation's *bylaws* integrated with such agreement. Any uncertainty would probably be resolved by *requiring* normal corporate procedures and formalities.

(a) [3:277] **Comment:** Even if the agreement specifically waives all meetings and formalities, this does *not* mean those running the business can operate in a completely unstructured manner. Most shareholder agreements require (or would be construed by courts to require) minimum standards of reports and accountability by those running the business to the other investors, similar to the fiduciary duties owed by partners to each other (¶ *6:169, 6:285 ff.*).

(2) [3:278] **As required for business purposes:** Also, for financial reasons, the corporation may have to show compliance with normal corporate procedures and formalities. *Banks and other institutions invariably require certified copies of enabling resolutions* by a corporation's board of directors to open a bank account, or to extend credit to the corporation. Thus, certain meetings and formalities become a practical necessity.

(3) [3:279] **As required for tax purposes:** Finally, the Internal Revenue Service may take the position that failure to follow normal corporate procedures (even though pursuant to a shareholder agreement) constitutes grounds to disregard the corporation as a separate taxable entity, and to treat it as a partnership for tax purposes … usually with the result of increasing the tax burden on the shareholders.

d. [3:280] **Shareholders usually required to guarantee bank loans:** Banks are generally reluctant to make loans to small corporations without personal guarantees (*see* ¶ *2:48*). This reluctance is even stronger in the case of close corporations.

➪ [3:281] ***PRACTICE POINTER:*** This is a serious problem where some of the principals are more creditworthy than others. They may be unwilling to be "at risk" for the entire loans made to the corporation, and want to limit their guarantees to their proportionate shareholding. However, banks are generally not willing to accept guarantees on a proportionate basis.

e. [3:282] **Potential personal liability for managerial decisions:** As mentioned earlier, the shareholders of a close corporation may be held personally liable to the creditors of the corporation for managerial acts (or omissions) performed pursuant to authority granted them under the shareholders agreement. In short, the fiduciary liability which might be imposed upon the directors for managerial decisions is shifted to the shareholders. [Corps.C. § 300(d); *see* ¶ *3:252*]

(1) [3:283] **Which shareholders?** The statute provides that *transferees* who had notice of the shareholders agreement shall be deemed parties to the agreement, in place of their transferors. [Corps.C. § 300(b); *see* ¶ *3:267*]

However, it is not clear from the statute whether *all* parties to the shareholders agreement can be held personally liable or just those active in the management. (Presumably, managerial liability, like directors' liability, ¶ *6:244*, should extend to all those who have managerial *authority*.)

(2) [3:284] **What acts?** Apparently, creditors of the corporation can hold the shareholders liable for any acts for which directors could be held liable: e.g., unlawful distributions of dividends; liquidation of corporation without paying creditors; loaning corporate assets or guaranteeing a loan to themselves or corporate employees, etc. [Corps.C. § 316]

(3) [3:285] **What limits on liability?** It is not clear whether the same limitations recognized as to directors' liability (*see* ¶ *6:243*) would apply where liability is sought to be imposed on shareholders of a close corporation for managerial acts or omissions.

• [3:286] It is *doubtful* that shareholders active in management could escape liability by “good faith reliance” upon information furnished by others, as a director may. [See Corps.C. § 309(b); ¶ *6:248*]

• [3:287] In connection with issuance of shares, it is not clear whether the judgment of shareholders as to the *value of the consideration* for the shares would be conclusive, as it is in the case of directors (absent fraud). [See Corps.C. § 409(b); ¶ *3:318*]

• [3:288] Nor is it clear whether a shareholder who is not otherwise an officer, director or employee of the corporation, would be entitled to *indemnification* from the corporation. [See Corps.C. § 317; ¶ *6:436*] (Presumably, indemnification would be available for shareholders active in management on the theory they acted as “agents” of the corporation.)

f. [3:289] **Potential tax problems:** There may be significant income tax problems created by use of a shareholders agreement that alters normal corporate structures:

(1) [3:290] **Disqualification from S election:** If the shareholders agreement allocates profits or other financial rights disproportionately to share ownership, the corporation may be deemed to have two or more classes of stock outstanding (i.e., certain shares may be deemed to have *preferential rights*). If so, this would disqualify the corporation from electing to be taxed as an S corporation. [IRC § 1362(d); Treas.Reg. § 1.1361-1(*l*); *and see* ¶ *2:145*]

(2) [3:291] **Costs not deductible:** Payments made by a corporation in connection with stock reacquisitions generally are not deductible; *see* ¶ *7:228.1 ff.*

(3) [3:292] **Liquidation distributions taxable as ordinary income:** Ordinarily, where a shareholder receives distributions in liquidation of the corporation, gain is taxable at the lower rates applicable to capital gains and dividends (IRC § 331; *see* ¶ *8:1152*). But if the shareholders agreement in a close corporation provides for a distribution disproportionate to an *active* stockholder's ownership interest, the excess might be taxable at the higher ordinary income rates as compensation for *services*.

g. [3:293] **Potential problems under securities law:** The terms of the shareholders agreement may also raise problems under the California Corporate Securities Law. This is because the shareholders agreement is considered one of the “charter documents” (like the articles of incorporation). [Commr. Rule 260.001(a), (h)]

Thus, any change in shareholder rights, preferences and privileges effected by such agreement is considered a “sale” of securities, and is subject to qualification unless an appropriate *exemption* exists. [Commr. Rule 260.017.2]

(1) [3:293.1] **Permit needed to adopt agreement?** Indeed, the Commissioner of Financial Protection and Innovation may take the view that such a shareholders agreement *itself* constitutes a change in the rights, preferences and privileges of the issued shares. If so, a permit from the Commissioner would be required *prior to adoption* of such agreement or any subsequent amendment or modification thereof. [See Commr. Rule 260.017.2]

However, given the statutory imprimatur to close corporation shareholder agreements granting shareholders broad flexibility in tailoring corporate governance to fit their needs, and the limitation on the number of shareholders to no more than 35, the exercise of any such authority by the Commissioner would appear unwarranted.

(2) [3:293.2] **Potential exemptions from qualification:** In any event, counsel's role is to find an appropriate exemption, if one exists:

(a) [3:294] **Disqualification for § 25102(h) exemption:** This exemption is available only to corporations issuing a *single class* of common stock. Thus, if the shareholders agreement alters or varies the normal rights of the shareholders, by allocating greater voting rights or profits to certain shareholders than others, the corporation may be deemed to have several classes of shares outstanding, disqualifying it from claiming an exemption under Corps.C. § 25102(h). (*See ¶ 5:225*.)

(b) [3:295] **Compare—§ 25102(f) exemption still available:** However, the exemption from qualification provided by Corps.C. § 25102(f) may still be available notwithstanding the problems under Corps.C. § 25102(h). (*See ¶ 5:256*.)

h. [3:296] **Potential problems and costs in drafting shareholders agreement:** The shareholders agreement is the heart of the close corporation. Considerable time and effort is generally required to draft the agreement, and doing so may run up the costs to the point that the close corporation is not worthwhile.

6. [3:297] **Terminating Close Corporation Status:** There are two ways by which close corporation status may be terminated:

a. [3:298] **By amendment of articles of incorporation:** Close corporation status may be terminated by an amendment to the articles *deleting* the statement, "This corporation is a close corporation." [Corps.C. § 158(c)]

(1) [3:298.1] **Corporate approval requirement:** If no shares have yet been issued, such an amendment is valid if signed by a majority of incorporators; or if directors have been elected, by a majority of directors. [Corps.C. § 158(c)]

If shares have been issued, the amendment, like all other articles amendments, must be approved by a majority of directors (unless the shareholders agreement eliminated the board or otherwise dispensed with such approval; *see ¶ 3:248 ff.*). The amendment must also be approved by the shareholders; however, the unanimity required for electing close corporation status (*see ¶ 3:239*) is not required for the amendment. Instead, the amendment need be approved by only *two-thirds* of the outstanding shares (unless the articles provide for a *lesser* majority vote). [Corps.C. § 158(c); see Corps.C. § 902(a), (f)]

(2) [3:299] **Prior agreement to amend:** The shareholders may agree in advance to vote for the deletion of close corporation status upon the lapse of a specified period of time or the occurrence of some other event or condition. In this event, their agreement will be given effect. [Corps.C. § 158(f)]

b. [3:300] **By transfers increasing number of shareholders:** Close corporation status is *automatically* terminated whenever the corporation has a greater number of shareholders than permitted by the articles of incorporation (which may not exceed 35). [Corps.C. § 158(e)]

(1) [3:301] **Disqualifying transfers:** As long as the requisite legend appears on the share certificate (¶ 3:241), no voluntary inter vivos transfer can terminate close corporation status. Any attempted inter vivos transfer that would increase the number of shareholders above the permitted number would be *void*. [Corps.C. § 418(d); see also Corps.C. § 2800(e) (SPCs); *and ¶ 3:271*]

[3:302] But any of the following transfers which would increase the number of shareholders above the number permitted in the articles, will *automatically* terminate close corporation status:

• Transfers by will, or the laws of descent and distribution of decedents' estates;

• Transfers upon dissolution of a partnership, corporation, business association or trust which holds the shares; and

• Transfers on dissolution of marriage or otherwise by operation of law. [Corps.C. § 158(e)]

➪ [3:303] ***PRACTICE POINTER:*** Loss of close corporation status through disqualifying transfers can be avoided by including appropriate provisions in the shareholders agreement. The corporation, or the remaining shareholders, can be given the option to purchase (or buy back) the shares in question to prevent the types of transfers enumerated above (¶ 3:300 ff.). The *terms* of the option or agreement would have to be enforceable; i.e., setting a firm price or at least a formula for determining the price, if one of the disqualifying events occurs. (And, of course, if the corporation is to repurchase its own shares, it must have sufficient accumulated earnings or net worth to do so; see Corps.C. §§ 500-503, *discussed at ¶ 7:10 ff.*)

(2) [3:304] **Articles must be amended:** Promptly upon acquiring more than the permitted number of shareholders, and thereby losing its close corporation status, the corporation must execute and file an amendment to its articles deleting the

special provisions relating to close corporations. The directors are required to approve such amendment, but no shareholder approval is necessary. [Corps.C. § 158(e); *see* ¶ *8:71*]

c. [3:305] **By issuing shares to new shareholder:** If the corporation issues shares to a new shareholder who *refuses* to become a party to the existing shareholders agreement, the shareholders agreement terminates (unless it expressly provides that it shall continue and the agreement is otherwise enforceable). [Corps.C. § 300(b); *see* ¶ *3:268*]

➪ [3:305.1] ***PRACTICE POINTER:*** Practitioners avoid this possibility by conditioning issuance of shares to a new shareholder upon the new shareholder's executing or adopting the shareholders agreement.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 3-E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

E. Planning Re Issuance of Shares

1. Corporate Law Considerations re Share Issuance
  a. [3:307] Requirement of lawful consideration for shares
    (1) [3:308] Illegal consideration
      (a) [3:309] Exception for shares issued under employee stock option and stock purchase plans
        1) [3:310] The Code requires only that…
        2) [3:311] As discussed below (¶ *3:312 ff.*), there…
      (b) [3:311.1] Compare—consideration for LLC or limited partnership interests
    (2) [3:312] Planning around prohibition on unsecured promissory notes
    (3) [3:313] Planning around prohibition against stock for future services
      (a) [3:314] Example—use of stock option
      (b) [3:315] Problem cases
        1) [3:316] Comment
        2) [3:317] Compare—securities law limitation on "promotional" stock
  b. [3:318] Valuation of noncash consideration
    (1) [3:319] Valuation by shareholders rather than directors
    (2) [3:320] Valuation methods
  c. [3:321] Partially-paid shares
    (1) [3:322] Dividend rights limited
    (2) [3:323] Liability to corporation for balance
    (3) [3:324] Transfer of shares as transfer of liability
      (a) [3:325] If for any reason the…
    (4) [3:326] Liability to creditors
      (a) [3:327] Nature of proceedings
      (b) [3:328] Which creditors
      (c) [3:329] Defenses to creditors' action
2. [3:330] Taxable vs. Nontaxable Issuance of Shares
  a. [3:331] Requirements for tax-free incorporation
    (1) [3:332] Transfer of property
      (a) [3:333] Compare—services
      (b) [3:334] Transfer of both property and services
        1) [3:335] Transfer still effective for "control" purposes
    (2) [3:336] Transfer must be "solely in exchange for stock"
      (a) [3:337] "Stock"

(b) [3:340] "Boot" taxable
1) [3:340.1] "Nonqualified preferred stock" as "boot"
a) [3:340.2] Participating preferred stock may avoid "boot" treatment
1/ [3:340.3] Conversion feature insufficient to avoid "boot" treatment
b) [3:340.4] Exceptions re redemption/purchase rights
c) [3:340.5] Recognition of loss
(c) [3:341] Corporation's assumption of transferor's liabilities not "boot"
1) [3:342] Effect on basis of stock issued by corporation
2) Circumstances in which assumption of liabilities treated as boot
a) [3:343] Tax avoidance purpose
b) [3:344] Liabilities exceed basis
3) [3:345.1] Liabilities in conjunction with transfer of accounts receivable
(3) [3:346] Transferors must have "control" immediately after the exchange
(a) [3:347] "Control"
1) [3:348] Attribution rules not applicable
2) [3:348.1] Power to elect directors
3) [3:349] Stock issued partly for services
4) [3:349.1] Compare—stock issued for services to incorporating proprietorship
(b) [3:350] "Immediately after the exchange"
1) [3:351] Risk where several transfers made separately
2) [3:353] Risk of subsequent transfers
a) [3:354] Example
b) [3:355] Compare—distributions from corporate-transferor
b. [3:356] Tax basis on property transferred and stock issued in tax-free incorporation
c. [3:359] Tax-planning considerations—advantages vs. disadvantages of tax-free incorporation
(1) [3:360] Situations in which desirable to recognize gain at time of transfer
(2) [3:365] Methods to avoid tax-free treatment
d. [3:367.5] Compare—state sale tax
3. [3:368] Securities Law Considerations re Share Issuance
4. [3:369] Planning re Documentation
a. [3:372] Notice to creditors; effect of bulk sales statute

[3:306] Before organizing the corporation, the participants need to plan the nature and amount of securities the corporation will issue as part of its initial capitalization, and they need to consider the corporate law, tax law and securities law ramifications of the capitalization plan.

(They also need to make a *good faith* effort to assure that the initial capitalization is "adequate" for the proposed business; *see discussion at ¶ 3:29 ff.*)

1. Corporate Law Considerations re Share Issuance

a. [3:307] **Requirement of lawful consideration for shares:** There are limits on the consideration for which a corporation may issue its shares. Shares may be issued only for:

• Money paid;

• Labor *done* (i.e., past services actually rendered to the corporation or for its benefit in its formation);

• Debts or securities cancelled (as in a reorganization); and

• *Tangible* or *intangible* property received either by the corporation or a wholly-owned subsidiary. [Corps.C. § 409(a)(1)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [3:308] **Illegal consideration:** The Code specifically provides that shares may *not* be issued for:

• **Future services**, to be performed by the issuee or anyone else; or

• **Promissory notes** of the purchaser, unless "adequately secured" by collateral other than the shares themselves … or unless pursuant to a duly-adopted employees' stock purchase or stock option plan (¶ 3:309 ff.). [Corps.C. § 409(a)(1)]

(a) [3:309] **Exception for shares issued under employee stock option and stock purchase plans:** The prohibition against unsecured promissory notes as consideration does not apply to shares purchased by employees (or directors) under stock purchase or stock option plans—i.e., an employee's unsecured notes alone are adequate consideration for the shares so issued. [See Corps.C. §§ 409(a), 408]

1) [3:310] The Code requires only that any such plan be adopted by the board of directors (Corps.C. § 408). But shareholder approval is also required to qualify the plan for favorable tax treatment (see "employee incentive stock options," ¶ 2:219), or if the corporation is publicly-traded, as required by the rules of the exchange on which the corporation's outstanding shares are traded. [See, e.g., NYSE American Company Guide § 711; Nasdaq Stock Mkt. Rule 5635(c) & IM 5635-1]

2) [3:311] As discussed below (¶ 3:312 ff.), there are statutory restrictions on "partly-paid" shares (limitations on dividends, etc.); see Corps.C. § 409(d), *¶ 3:321*. It is not yet clear whether shares issued to employees for their unsecured promissory notes (as authorized by § 408) would be treated as "partly paid shares," and subject to such restrictions.

(b) [3:311.1] **Compare—consideration for LLC or limited partnership interests:** An LLC member need only contribute "any benefit" in return for their membership interest. [Corps.C. §§ 17701.02(c), 17704.02; *see ¶ 2:36.26*]

Similarly, a limited partner's capital contribution may consist of tangible or intangible property "*or other benefit*" to the limited partnership (including money, services performed, promissory notes, other agreements to contribute cash or property, and contracts for services *to be performed*). [Corps.C. § 15905.01 (emphasis added); *see ¶ 2:29*]

(2) [3:312] **Planning around prohibition on unsecured promissory notes:** As stated above (¶ 3:308), shares may not be purchased merely with unsecured promissory notes of the purchaser. But this prohibition does not apply to unsecured promissory notes of *others* held by the purchaser and endorsed to the corporation (e.g., relatives of the purchaser). Nor does it apply to the purchaser's own promissory notes if "adequately secured" by collateral other than the shares themselves. (It is up to the board of directors to determine whether the security offered is "adequate.")

(3) [3:313] **Planning around prohibition against stock for future services:** The prohibition against issuing shares for future services is not an insurmountable problem. Employees can obtain shares through "bargain" options. Shares can also be issued to employees for other, lawful consideration (not future services), such as manufacturing processes contributed to the corporation, knowledge of potential customers, contracts with foreign suppliers, etc. Absent fraud, the board's determination of the consideration to be received for the shares, and the value thereof, is conclusive. [See Corps.C. § 409(b), ¶ 3:318]

(a) [3:314] **Example—use of stock option:** If it is desired to give a key employee 25% of the stock of a business being incorporated, the corporation could issue 75 shares to the owners of the business and give the key employee an *option* to purchase shares at the same original price per share as paid for the 75 shares, exercisable if the employee is still in the corporation's employ at the end of five years. (Or, the stock could be issued outright with the employee paying the same price as the other investors but giving the corporation the right to repurchase the stock during the first five years.)

Therefore, it is possible to issue shares in expectation of, and even conditioned upon, future employment or future services to the corporation. (As to the tax consequences of shares issued for past or future services, see IRC § 83, *discussed at* ¶ 2:171 ff., and IRC § 409A, *discussed at ¶ 2:174.1*.)

(b) [3:315] **Problem cases:** Problems may arise where shares are being issued for "*management know-how*" or for a "*covenant not to compete*." Do these constitute intangible property (lawful consideration) or a promise to perform *future* services (illegal consideration)?

1) [3:316] **Comment:** Each case has to be decided on its own facts, but courts generally seek to *uphold* the transaction if possible. Thus, lawful consideration will probably be found where it is possible for the corporation to utilize whatever benefits it has received from the transferor *apart from* continued services from the transferor.

2) [3:317] **Compare—securities law limitation on "promotional" stock:** Shares issued for services rendered in organization of the corporation, or for assets that have no clear market value (e.g., goodwill, customers' lists, patents, copyrights, etc.), are regarded as "promotional stock" by the California Commissioner of Financial Protection and Innovation (formerly the Business Oversight Commissioner). Thus, if qualification is required (i.e., no available exemption), special limitations are imposed—generally no more than 25% of the total shares issued. [See Commr. Rules 260.140.30 & 260.140.31; ¶ 5:329]

b. [3:318] **Valuation of noncash consideration:** Whenever noncash assets are offered to the corporation in exchange for its shares, a value must be placed thereon in order to establish the amount of shares to be issued (*see ¶ 4:460*). The board of directors must, by resolution, determine the fair value to the corporation, in *monetary* terms (i.e., *dollars*), of the assets or services received. In the absence of fraud, the *board's determination of value is conclusive* (so that creditors or shareholders cannot later object). [Corps.C. § 409(a), (b)]

(1) [3:319] **Valuation by shareholders rather than directors:** Although it is rather unusual, the articles may reserve to the shareholders the right to determine the consideration for issuance of additional stock (*see ¶ 4:102*). In such a case, the determination of value would have to be made by approval of a majority of the outstanding shares. [Corps.C. § 409(c)] Obviously, the initial issuance would have to be valued by the directors, because there would be no shareholders at that time.

• ***FORM:*** Optional Articles Provision Establishing Shareholders' Right to Determine Consideration for Share Issuances, *see Form 4:A.1q*.

(2) [3:320] **Valuation methods:** *See ¶ 1:108*.

c. [3:321] **Partially-paid shares:** Although shares may not be issued solely for a promissory note (*see ¶ 3:308*), a corporation may properly issue shares which have only been partially paid for. In such event, however, the *share certificate must bear an appropriate notation*, stating the amount due on the shares. (If the corporation has adopted a system of uncertificated shares, such notation must appear on the "initial transaction statement"; *¶ 5:474*.) [Corps.C. §§ 409(d), 410]

(1) [3:322] **Dividend rights limited:** As long as any balance is due on the shares, dividends can be paid only in proportion to the consideration actually received by the corporation. [Corps.C. § 409(d); *see ¶ 7:14*]

(2) [3:323] **Liability to corporation for balance:** The person to whom partially paid shares are issued is liable to the corporation for the balance due under the subscription agreement, in accordance with its terms. [Corps.C. § 410(b)]

(3) [3:324] **Transfer of shares as transfer of liability:** As long as the share certificate (or "initial transaction statement"; ¶ 5:474) bears the required notation of balance due (¶ 3:321), any transferee becomes *personally* liable for the amounts coming due after the transferee acquires the shares. And the transferor is *discharged* from liability as to such amounts (unless the subscription agreement or share certificate provides otherwise). [Corps.C. § 412]

(a) [3:325] If for any reason the required notation was omitted from the share certificate, the transferee would be personally liable only if the transferee had *actual* knowledge of the balance due upon acquiring the shares (and even then would not be liable if the shares were acquired *through* a bona fide purchaser). [See Corps.C. § 412]

(4) [3:326] **Liability to creditors:** If the corporation becomes insolvent, persons owing subscription balances (including transferees, *see ¶ 3:324*) can be held personally liable by *judgment creditors* of the corporation, or the corporation's trustee in bankruptcy. [Corps.C. § 414]

(a) [3:327] **Nature of proceedings:** The proceedings are in the nature of a creditor's bill in equity—i.e., the creditor seeks to be placed in the shoes of the corporation, in order to enforce the corporation's claim for the monies due under the subscription agreement. [See *Spencer v. Anderson* (1924) 193 C 1, 4, 222 P 355, 356-357]

(b) [3:328] **Which creditors:** An action to impose such liability can be maintained only by *creditors holding a final judgment* against the corporation, *after writ of execution has been returned unsatisfied* in whole or in part (or on showing that execution would be useless). [Corps.C. § 414(a)]

However, once such action is filed, *any other corporate creditors* (with or without reducing their claims to judgment) *may intervene* in such action. Moreover, they may also join as codefendants any other shareholders owing unpaid subscription balances. This enables the creditors to obtain full and equitable recovery on their respective claims from all such shareholders in a single action. [Corps.C. § 414(b)]

(c) [3:329] **Defenses to creditors' action:** Since the shareholders' liability is based on a contract with the corporation, they may assert as defenses to the creditor's action whatever defenses they would have if sued by the corporation. The usual defense asserted is *fraud* (e.g., misrepresentation as to material facts surrounding organization of corporation or

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

issuance of securities). (In contrast, the corporation's insolvency, and consequent worthlessness of the securities, is *not* a valid defense.)

2. [3:330] **Taxable vs. Nontaxable Issuance of Shares:** When shares are issued for cash, there are no tax consequences to either the purchasing shareholder or the corporation. There is no gain or loss on the transaction.

However, where stock or securities are issued in exchange for *property* or *services rendered*, there may be tax consequences both to the corporation and the shareholder. The tax treatment depends on whether the transaction qualifies as a tax-free organization under IRC § 351. (*See* ¶ *2:161*.)

a. [3:331] **Requirements for tax-free incorporation:** No gain or loss is recognized if *property* is transferred to a corporation *solely* in exchange for stock (other than "nonqualified preferred stock," ¶ *3:340.1 ff.*), and immediately after such exchange the transferors are in *control* of the corporation, as defined below (¶ 3:347). [IRC § 351(a)]

(1) [3:332] **Transfer of property:** First of all, to qualify as a tax-free incorporation, the investor must exchange *property* for stock. "Property" is given a broad definition. It includes cash and any form of property, *tangible or intangible*. Thus, patents, trademarks, trade names and the like qualify as "property" for tax-free incorporation purposes.

Technical "know-how" may also qualify as property if it consists of something like secret processes or customers lists, which are *capable of being utilized apart from any continued services by the transferor*. [See Rev.Rul. 64-56, 1964-1 CB 133; and Rev.Proc. 69-19, 1969-1 CB 301]

(a) [3:333] **Compare—services:** But services are *not* property, and hence shares issued in exchange for services previously rendered to the corporation do *not* qualify for tax-free incorporation. Instead, such issuance results in *taxable income* to the issuee on the value of the shares received. [See IRC § 351(d)(1); and IRC § 83, ¶ *2:171*]

Correspondingly, the transferor-corporation is entitled to *deduct* (as compensation expense) the value of the stock or securities so issued (*see* ¶ *2:175*).

(b) [3:334] **Transfer of both property and services:** Where stock is issued in exchange for *both* property and services (e.g., stock issued for patent rights and promotional services in organizing corporation), the shareholder has taxable income on the value of the *shares attributed* as being issued in consideration for the services rendered.

1) [3:335] **Transfer still effective for "control" purposes:** As discussed below (¶ 3:346 ff.), another requirement for tax-free incorporation is that transferors of *property* (not services), in the aggregate, "control" the corporation immediately after the transfer. The fact that shares have been issued *partly* for services does *not* disqualify the issue from being considered part of the "control" group, so long as (i) some other portion of the shares was designated as having been issued for the *property* transferred, and (ii) the property is "not of relatively small value" as compared to the services. [See Treas.Reg. § 1.351-1(a)(1)(ii)]

Property transferred for shares will qualify under this test if its fair market value is at least 10% of the value of shares already owned or to be received for services. [See Rev.Proc. 77-37 ¶ 3.07, 1977-2 CB 568, 570]

(2) [3:336] **Transfer must be "solely in exchange for stock":** The second requirement for tax-free incorporation is that the transfer of property must have been made *solely* in exchange for *stock*. [IRC § 351(a)]

(a) [3:337] **"Stock":** The term "stock" includes common and preferred stock (but *excludes* "nonqualified preferred stock," ¶ *3:340.1*). "Stock" also includes *debt reclassified as equity* under IRC § 385 (*see* ¶ *3:41*).

However, stock rights or options, or warrants to purchase stock, are *not* "stock"; these would be treated as "boot" (¶ 3:340 ff.). [Treas.Reg. § 1.351-1(a)(1)(ii)]

[3:338 - 3:339] ***Reserved.***

(b) [3:340] **"Boot" taxable:** If, in *addition* to its stock, the corporation pays money or other property, or issues securities such as debt instruments or "nonqualified preferred stock" (¶ 3:340.1) for the assets transferred, such money, property or securities are treated as "boot"—i.e., taxable gain is recognized up to the amount of money or the value of the property or securities received from the corporation. (But no loss is recognized on such transactions, except as noted at ¶ 3:340.5.) [IRC § 351(b)]

(The "boot" will be taxed as ordinary income or capital gain, depending on whether the property transferred to the corporation is a capital asset.)

1) [3:340.1] **"Nonqualified preferred stock" as "boot":** Subject to certain exceptions described below (¶ 3:340.2 ff.), "nonqualified preferred stock" is treated as "boot." Reason: Such stock closely resembles debt in many ways, and thus is treated as the equivalent of debt for tax purposes. [See Treas.Reg. § 1.356-6]

"Nonqualified preferred stock" is stock that (i) is *limited and preferred* as to *dividends*, (ii) does *not participate in corporate growth* to any significant extent (*see ¶ 3:340.2*), and (iii) has any of the following characteristics:

• The holder has the right to require the corporation (or a "related person"—e.g., an affiliate or a more-than-50% shareholder) to redeem or purchase the stock;

• The corporation (or a related person) is required to redeem or purchase the stock;

• The issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, is more likely than not to exercise the right; *or*

• The dividend rate varies in whole or in part with reference to interest rates, commodity prices or similar indices. [IRC §§ 351(g)(2)(A), (3) & 354(a)(2)(C)]

a) [3:340.2] **Participating preferred stock may avoid "boot" treatment:** As stated above (¶ 3:340.1), preferred stock is "nonqualified" if it is limited as to dividends and does not participate in corporate growth—i.e., it lacks "a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation." [IRC § 351(g)(3)(A)]

IRC § 305 (dealing with stock distributions) also uses the concept of "participation in corporate growth," and regulations indicate that preferred stock participates in corporate growth if it is entitled to participate "over and above" its stated priority on distributions "with another less privileged class of stock in earnings and profits and upon liquidation." [Treas.Reg. § 1.305-5(a)]

Accordingly, preferred stock having the right to receive dividends and other distributions *in addition to* its stated preference (*see ¶ 3:104*) should avoid treatment as "nonqualified preferred stock" (unless facts and circumstances, such as the existence of other classes of stock with superior dividend rights, render the participation more illusory than real). [See Treas.Reg. § 1.305-5(a)]

1/ [3:340.3] **Conversion feature insufficient to avoid "boot" treatment:** A feature making the preferred stock convertible or exchangeable into other stock of the corporation (or into stock of a related corporation) does *not itself* cause the stock to "participate in corporate growth." [See Treas.Reg. § 1.305-5(a)]

b) [3:340.4] **Exceptions re redemption/purchase rights:** Despite the existence of redemption or purchase rights (*¶ 3:340.1*), the preferred stock will not be treated as "nonqualified" (i.e., the stock will *not* be taxed as "boot") if:

• The redemption or purchase right or obligation cannot be exercised within *20 years* of issuance; or

• The right or obligation is subject to a *contingency* that, as of the issue date, makes the likelihood of redemption or purchase *remote*; or

• The corporation (or a related corporation) has *no* class of "readily tradable" stock and the right or obligation is exercisable only upon the holder's *death*, *disability* or *incompetency*; or

• The stock was issued as *reasonable compensation* for *services rendered* and the right or obligation is exercisable only upon the holder's *separation from service*. [IRC § 351(g)(2)(B), (C)]

c) [3:340.5] **Recognition of loss:** As an exception to the general rule that loss is not recognized in a IRC § 351 exchange (*¶ 3:340*), loss *will be recognized* on a transfer of property exchanged either solely for nonqualified preferred stock or for a combination of nonqualified preferred stock and other "*boot*." In effect, the transferor is treated as having *sold* the property to the corporation, and thus may recognize loss (so long as the loss is not otherwise disallowed—e.g., under IRC § 267 for sales between "related taxpayers," *¶ 3:364*). But *no loss* is recognized where the transferor receives nonqualified preferred stock *and other stock* in the exchange. [IRC § 351(g)(1)(B)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [3:341] **Corporation's assumption of transferor's liabilities not "boot":** Often, when a business is transferred to a corporation in exchange for its stock, the corporation will assume the transferor's liabilities as part of the transaction. Or, where property is transferred subject to a lien, the corporation will assume the liability represented thereby.

To the extent such liabilities are assumed, the transfer is not "solely" in exchange for stock. Nevertheless, the corporation's assumption of such liabilities *does not ordinarily constitute "boot."* Even though it may improve the transferor's financial position (because the transferor is now, at most, only secondarily liable), an assumption of liabilities is not "money" or "property" within the meaning of IRC § 351. [IRC § 357(a)]

1) [3:342] **Effect on basis of stock issued by corporation:** The transferor whose liabilities have been assumed by the corporation must reduce their basis on the stock or securities issued to him by the amount of such liabilities. [See IRC § 358(a)(1),(d)]

2) Circumstances in which assumption of liabilities treated as boot

a) [3:343] **Tax avoidance purpose:** The corporation's assumption of the transferor's liabilities *will* be treated as taxable "boot" where the principal purpose appears to be *tax avoidance* (e.g., transferor recently borrowed heavily against the property, squeezing out as much equity as possible, and then transferred the property to the corporation, in contemplation of tax-free treatment) or there was otherwise *no bona fide business purpose* for the transaction. [IRC § 357(b)]

b) [3:344] **Liabilities exceed basis:** Where the liabilities assumed by the corporation exceed the transferor's basis in the transferred property (as where the property has been depreciated below the amount of liens against it), the excess is taxable as gain to the transferor-shareholder. [IRC § 357(c); see *Seggerman Farms, Inc. v. Commr.* (7th Cir. 2002) 308 F3d 803, 806—transfer resulted in taxable gain notwithstanding shareholders' guaranty of liabilities assumed by corporation]

➪ [3:345] ***PRACTICE POINTER:*** To avoid recognition of gain, the transferor can increase basis by contributing to the corporation *other property*, including the transferor's own promissory note (provided it is bona fide and enforceable), so that the transferred liabilities do not exceed basis. [See *Peracchi v. Commr.* (9th Cir. 1998) 143 F3d 487, 492-496]

3) [3:345.1] **Liabilities in conjunction with transfer of accounts receivable:** In the past, tax-free status was sometimes in doubt where the assets transferred to the corporation consisted in large part of accounts receivable—as was often the case with incorporation of a going business. If the transferors (partners or proprietors) were cash-basis taxpayers, their accounts receivable had a *zero* tax basis—because they had not yet realized the income that gave rise to the receivables. Thus, if the new corporation assumed sizable liabilities in connection with the transfer, such liabilities often exceeded the basis of the assets transferred, and the exchange was not tax-free.

However, the Code now provides that for the purpose of a tax-free exchange, a liability is not considered (in determining whether liabilities exceed the basis of the property transferred) *if payment of that liability would have given rise to a deduction* by the unincorporated taxpayer. The effect is that most accounts *payable* are excluded (since they would have given rise to a deduction). [IRC § 357(c)]

(3) [3:346] **Transferors must have "control" immediately after the exchange:** The final requirement for tax-free incorporation is that the corporation must be "controlled" by transferors of property immediately after the exchange of their property for the corporation's stock. [IRC § 351(a)]

(a) [3:347] **"Control":** "Control" means ownership of at least 80% of the total combined voting power of *all* classes of stock entitled to vote, and at least 80% of the total *number* of shares of all other classes of stock of the corporation. [IRC § 368(c); see Rev.Rul. 59-259, 1959-2 CB 115]

1) [3:348] **Attribution rules not applicable:** For various other tax purposes, ownership by family members, partners, etc., may be attributed to the taxpayer (IRC § 318, *see ¶ 7:232*). However, such attribution rules do *not* apply in determining "control" for tax-free incorporation. The transferors of the assets must end up with at least 80% "control" *themselves*—without regard to shares held by relatives, business associates, etc.

2) [3:348.1] **Power to elect directors:** Stock "entitled to vote," in the context of "control," generally connotes the power to vote for *directors*; and, while there is no known authority directly in point, that is probably what is

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

contemplated by IRC § 368(c). Consequently, to obtain tax-free treatment, the transferors must end up with stock having the power to elect *80% of the directors*.

However, the IRS does not apply a purely mechanical "control" test, and ownership of voting stock sufficient to elect directors having 80% of the board votes does not automatically equate with "control." Thus, where corporate charter provisions or other shareholder arrangements significantly restrict board discretion and authority by subjecting various corporate decisions to approval of *each class* of voting stock, the holders of voting stock of *one* class, nominally entitled to elect directors having 80% of the board's total voting power, do not "control" the corporation. The transferors must own stock entitled to elect directors having 80% of the voting power with respect to *management of the corporation's business*. [See Priv.Ltr.Rul. (TAM) 9452002; see also Rev.Rul. 69-126, 1969-1 CB 218]

3) [3:349] **Stock issued partly for services:** Stock issued *solely* for services rendered (or to be rendered) to the corporation does *not* qualify for tax-free incorporation (¶ *3:333*). But where both services *and property* are transferred for shares, the shares issued for services may be counted in determining whether the transferor has obtained "control" (i.e., 80% or more of all voting stock and of all other shares) so long as the value of the property is not less than 10% of the value of the stock being issued for services. [Treas.Reg. § 1.351-1(a)(1)(ii); ¶ *3:335*]

4) [3:349.1] **Compare—stock issued for services to incorporating proprietorship:** Stock issued to an employee for past services rendered to an incorporating proprietorship may be treated as if was first issued to the proprietor (i.e., issued to the proprietor for the proprietorship *property*) and then paid to the employee as compensation for services to the proprietorship. Thus, such stock may be included in determining whether the proprietor-transferor has the required "control." (Of course, the employee would be taxed on the shares as compensation income, and the proprietor may have a corresponding business deduction.) [See Rev.Rul. 62-217, 1962-2 CB 59]

(b) [3:350] **"Immediately after the exchange":** To qualify for tax-free incorporation, the transferor (together with all other transferors) must end up with "control" of the corporation "immediately after" transfer of the property in exchange for stock. [IRC § 351(a)]

1) [3:351] **Risk where several transfers made separately:** Where several transferors join in transferring property to the corporation in exchange for 80% or more of its shares, the transfers should be made *concurrently;* i.e., as part of the same, single transaction. If they make separate transfers, there is a risk that no single transferor will have enough control "immediately after" the transfer to qualify for tax-free incorporation.

➪ [3:352] ***PRACTICE POINTER:*** This risk can be avoided by drafting a *single corporate resolution* authorizing the issuance of "control" shares in exchange for property from several different transferors (as opposed to separate resolutions for each transfer).

2) [3:353] **Risk of subsequent transfers:** Subsequent issuances of stock by the corporation to other issuees, or subsequent transfers by the initial issuees, resulting in their ownership being reduced to less than 80% may jeopardize the tax-free treatment under IRC § 351—especially if the subsequent issuance or transfer is deemed to be part of a single prearranged plan.

a) [3:354] **Example:** A and B transfer property to a new corporation in exchange for all of its stock. Shortly thereafter, they sell 25% of their shares to C, a key employee, for a relatively small cash price (or have the corporation issue additional shares to C). If the transfer to C (which reduces A's and B's control to under 80%) was pursuant to a *prearranged commitment* (e.g., a financial incentive to C to obtain his services), IRC § 351 would *not* apply to the original transfers made by A and B to the corporation.

b) [3:355] **Compare—distributions from corporate-transferor:** Tax-free treatment is available where a corporation transfers its assets to another in exchange for 80% or more of its stock, even if the transferor-corporation later distributes such stock to its own shareholders (e.g., in a merger or reorganization). The fact that none of its shareholders ends up with 80% control is *not* taken into account. [IRC § 351(c)]

b. [3:356] **Tax basis on property transferred and stock issued in tax-free incorporation:** If the transaction qualifies under IRC § 351, neither gain nor loss is recognized at the time. The corporation obtains as its tax basis in the assets received whatever basis they had in the hands of the transferor (i.e., a "carryover" tax basis). [IRC § 362(a)]

[3:357] Similarly, stock received by transferors in exchange for their property has the same tax basis as assets transferred, less any "boot" received (i.e., any money and the fair market value of any other property or securities received), and

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

less any liabilities assumed by the corporation, plus the amount of gain recognized by the transferor. In other words, the transferors take a "substituted" tax basis. [IRC § 358(a)]

[3:358] Recognition of gain or loss, either to the corporation or to the transferor-shareholder, is deferred until there is a taxable "sale or exchange": i.e., until the corporation later sells or disposes of the property it received from the transferor; and until the transferor-shareholder sells or otherwise disposes of the stock received. [IRC §§ 351(a), 358(a), 358(b)]

c. [3:359] **Tax-planning considerations—advantages vs. disadvantages of tax-free incorporation:** IRC § 351 is mandatory, not elective. Thus, if the transaction falls within its requirements, no gain (or loss) can be recognized on the transfer of property to the corporation in exchange for its shares—even if the parties *wanted* to treat the transfer as a taxable event.

(1) [3:360] **Situations in which desirable to recognize gain at time of transfer:** In some situations, the transferring shareholders may find it desirable to recognize gain or loss at the time of transfer, and it may benefit the transferee-corporation as well; for example:

• [3:361] **To obtain "stepped up" basis on property:** Where the assets being transferred consist of depreciable property which has increased in value but has a low tax basis, it may make sense to structure the transfer as a *taxable* "sale or exchange." The transferor will have a taxable capital gain, but the corporation will get a new, stepped-up tax basis in the property. This will provide greater depreciation deductions, and enable the corporation to accumulate more of its profits tax-free.

[3:362] **Caution:** The foregoing makes sense where the gain recognized by the transferor can be tax-sheltered or will be taxed as a capital gain. In contrast, it usually makes no sense to structure a taxable transfer where the transferor has taken heavy depreciation write-offs against the property, because the "excess depreciation" will be *recaptured* at *ordinary income* rates. [See IRC §§ 1245, 1250]

• [3:363] **Where loss can be recognized on transfer:** Conversely, if the property being transferred is worth *less* than the transferor's tax basis, it may be possible to structure the transfer as a taxable "sale or exchange," so that the transferor can take a *loss*.

[3:364] **Limitation:** Such losses are disallowed on sales between "*related taxpayers*," including a corporation *more* than 50% controlled by the transferor; so the particular transferor cannot own directly or indirectly (attribution rules apply) more than 50% of the shares being issued. [See IRC § 267(b)(2)]

(2) [3:365] **Methods to avoid tax-free treatment:** To insure that the issuance of shares falls *outside* IRC § 351, and that it will be treated as a *taxable* "sale or exchange," the corporation can:

• [3:366] Issue more than 20% of its initial shares to one or more organizers in exchange for past services—thus defeating the 80% control required by IRC § 351 (¶ *3:333*). The organizers will be taxable with compensation income based on the fair market value of the stock received (but this will probably be low in light of the limited market value of shares in closely-held corporations).

• [3:367] Pay for the property with securities (e.g., long-term debt) rather than shares. Since debt is not "stock" under IRC § 351, the transfer will be a taxable event (¶ *3:337*). The corporation will obtain an immediate stepped-up tax basis equal to the purchase price of the property, and thus can claim higher depreciation deductions. Of course, the transferor will have to pay taxes on the gain as the payments are received from the corporation (usually as an installment sale).

• [3:367.1] Violate the control "immediately after" requirement (¶ 3:350) by having a transferer enter into a binding agreement to sell to a third party more than 20% of the shares they receive in the exchange.

[3:367.2 - 3:367.4] ***Reserved.***

d. [3:367.5] **Compare—state sale tax:** *See* ¶ *2:177.5*.

3. [3:368] **Securities Law Considerations re Share Issuance:** Another obviously important consideration is whether the stock issuance will have to be registered and qualified under federal and state securities law … or whether it can be structured to fit within one or more available exemptions.

The federal and state securities law requirements are discussed in detail in Chapter 5, "Share Issuance: Securities Law Considerations," ¶ *5:13 ff.* These requirements must be *carefully* considered at the planning stage so that the organizers can structure the issuance to be exempt wherever possible.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

4. [3:369] **Planning re Documentation:** Also at the planning stage, counsel should consider what type of documentation will be required to effect transfer of the various noncash assets to the corporation.

[3:370] For example, where real property is to be transferred, counsel will need to prepare appropriate deeds. To do so, counsel may need to obtain legal descriptions of the property, and perhaps a preliminary title search (to verify ownership and liens outstanding).

[3:371] Where a going business is being transferred, counsel will need to draft assignments and bills of sale. To do so, counsel will need to obtain detailed inventory and description of the business, merchandise and inventory on hand at the transfer date; and its vehicles, equipment, licenses and permits. The contract by which the business is sold to the corporation will usually contain representations as to the assets and liabilities outstanding on the transfer date, and therefore accurate financial data will have to be prepared as of said date.

a. [3:372] **Notice to creditors; effect of bulk sales statute:** For certain types of businesses, notice to creditors must be given prior to a "bulk sale," which of course includes a sale of the business (see Comm'l C. § 6101 et seq.).

Noncompliance subjects the transferee (the new corporation) to a damages action for the amount of each "unnoticed" creditor's claim (less any "unrecoverable" amounts)—i.e., the only effect of noncompliance is to render the transferee liable to the transferor's creditors … which is usually what is intended by the organizers anyhow. See detailed discussion of "Bulk Sales Statutes" at ¶ *4:511 ff.*

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 3-F

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

F. Financing Arrangements Prior to Incorporation

- 1. [3:373] Obtaining Organizational Expenses
  - a. [3:374] Repayment by corporation
  - b. [3:375] Issuance of shares for funds advanced
  - c. [3:376] Securities law considerations
    - (1) [3:377] Section 25102(h) exemption
      - (a) [3:378] What constitutes "receipt of consideration"
    - (2) [3:379] Section 25102(f) exemption
- 2. [3:380] Preincorporation Subscription Agreements
  - a. [3:381] Purpose
    - (1) [3:382] Probably the only situation where…
    - (2) [3:383] In such cases, the preincorporation…
  - b. [3:384] Enforceability as contract
    - (1) [3:385] Revocability prior to formation?
  - c. Securities law requirements
    - (1) [3:386] Preincorporation subscriptions subject to Corporate Securities Law
    - (2) [3:387] "Nonpublic offering" exemption (Corps.C. § 25102(a))
      - (a) [3:388] Number of offerees
        - 1) [3:389] Counted persons
        - 2) [3:390] More than 35
      - (b) [3:391] Warning that agreement contingent
      - (c) [3:393] No transfer of funds or securities
      - (d) [3:394] Postformation compliance with CSL
        - 1) [3:395] Comment
- 3. [3:396] Close Corporations—Drafting Proposed Shareholders Agreement

1. [3:373] **Obtaining Organizational Expenses:** The costs and fees incurred in forming the corporation are usually advanced by the clients prior to formation. (The California Rules of Professional Conduct (CRPC) allow attorneys to advance incorporation fees, etc. (¶ 1:45), but it is preferable to have the client pay them; *see* ¶ *1:43*.)

a. [3:374] **Repayment by corporation:** Normally, the money advanced by the clients is repaid after the corporation is formed. A resolution is adopted at the organizational meeting of the board of directors, authorizing repayment of all organizational expenses out of the first funds obtained by the corporation upon issuance of its shares (*see* ¶ *4:448*).

b. [3:375] **Issuance of shares for funds advanced:** Alternatively, the directors may authorize the issuance of stock or other securities in repayment of the costs and fees advanced by the organizers.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

c. [3:376] **Securities law considerations:** Normally, it is unlawful for a corporation to borrow money from anyone with the understanding that the loan will be repaid by issuance of shares, unless a permit has been obtained from the Commissioner of Financial Protection and Innovation (formerly the Business Oversight Commissioner). Such an arrangement constitutes an "offer to sell" shares, and hence falls within the proscription of Corps.C. § 25110.

But such arrangements are permissible, and the shares issued thereunder are *exempt*, under the following circumstances:

(1) [3:377] **Section 25102(h) exemption:** The Corps.C. § 25102(h) exemption is discussed in detail at ¶ *5:224*. Suffice it to note here that shares may be issued pursuant to this exemption to repay loans made to the corporation by not more than 35 persons, who are (or expect to become) its officers, directors or controlling shareholder, or a partnership or partner whose business the corporation intends to acquire. The loans must not "substantially" exceed the amounts actually required to pay the corporation's *organizational expenses*, including attorneys' fees. And the corporation must not have commenced business activities, or issued shares, at the time such loans were made. [Commr. Rule 260.105.23]

(a) [3:378] **What constitutes "receipt of consideration":** One of the conditions of the Corps.C. § 25102(h) exemption is that the corporation file notice of the share issuance with the Commissioner of Financial Protection and Innovation within 10 days "after receipt of the consideration" for the shares. But "receipt of consideration" does *not* refer to loans. It is sufficient if the notice is filed within 10 days after the shares are issued. [Commr. Rule 260.102.11]

(2) [3:379] **Section 25102(f) exemption:** The Corps.C. § 25102(f) exemption is discussed in detail at ¶ 5:256 ff. Under this exemption, shares may be issued to up to 35 persons, if they have a preexisting relationship with the issuer or its principals, or otherwise are "sophisticated" investors. (They need *not* be officers, directors, etc.) Since the share issuance would be exempt, apparently advances against the purchase price of the shares would be permissible … and the proceeds could be used for *any* purpose (payment of organizational expenses or otherwise).

2. [3:380] **Preincorporation Subscription Agreements:** The organizers of the corporation may, even before forming the corporation, enter into agreements among themselves or with others to subscribe for shares of the proposed corporation.

a. [3:381] **Purpose:** In the past, preincorporation subscription agreements were used to arrange the corporation's financing during the weeks or months it might take to incorporate. However, due to simplified requirements for incorporation under modern law, and the increased speed with which corporate status may be achieved, preincorporation subscription agreements are no longer common.

(1) [3:382] Probably the only situation where a formal pre-incorporation subscription agreement would be desirable is where one or more of the potential investors appears likely to withdraw unless some formal agreement is prepared immediately. For example, where the persons who will run the business are being asked to give up other employment or to forego other profitable opportunities, they may be willing to do so only if the other investors are firmly bound.

(2) [3:383] In such cases, the preincorporation agreement can confirm the parties' respective obligations to purchase shares "when, as and if" the corporation is formed. Or, it may go on to address other matters relevant to the financing or control of the proposed corporation: e.g., the parties' understanding as to management of corporate affairs; including agreements with respect to corporate employment, salaries, profit-sharing, etc.

b. [3:384] **Enforceability as contract:** Preincorporation subscription agreements are generally viewed as contracts among the subscribers for the benefit of the proposed corporation. When it comes into existence, the corporation can enforce such contracts as third party beneficiary. [See Civ.C. § 1559]

(1) [3:385] **Revocability prior to formation?** Viewed as third party beneficiary contracts among the subscribers, none of them should have the power to revoke before the corporation comes into existence. However, there is some dicta suggesting to the contrary: i.e., that one of several subscribers *can* withdraw their subscription before the corporation is formed. [See *Moser v. Western Harness Racing Ass'n* (1948) 89 CA2d 1, 12, 200 P2d 7, 11; Civ.C. § 1559]

The validity of this position is questionable. A later case interpreted *Moser* as standing for the principle that California enforces preincorporation subscription agreements so long as the corporation is successfully incorporated. [*Theophilos v. Commr.* (9th Cir. 1996) 85 F3d 440, 446]

c. Securities law requirements

(1) [3:386] **Preincorporation subscriptions subject to Corporate Securities Law:** A preincorporation subscription is an agreement for sale of a security within the meaning of the Corporate Securities Law. It is, therefore, unlawful to negotiate

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

or execute a preincorporation subscription without obtaining a negotiating permit from the Commissioner of Financial Protection and Innovation, or coming within the terms of the *exemption*, below (¶ 3:387 ff.). [Corps.C. § 25110]

(2) [3:387] **"Nonpublic offering" exemption (Corps.C. § 25102(a)):** No permit is required if the preincorporation subscription does *not* involve a "public" offering. The following conditions must be met:

(a) [3:388] **Number of offerees:** Preincorporation subscriptions offered to no more than *35* (counted) persons, do *not* constitute a "public" offering. [Commr. Rule 260.102.1]

1) [3:389] **Counted persons:** Spouses count as one person. There is no limit on offerings to banks, trust companies and certain institutional investors, or persons regarded as "affiliates" of the issuer. [Commr. Rules 260.102.1, 260.102.13; and see Corps.C. § 25102(i)]

2) [3:390] **More than 35:** Preincorporation subscriptions offered to *more* than 35 persons may or may not constitute a "public" offering. Each case turns on its own facts. The fact that more than 35 persons are involved does not *per se* make it a "public" offering. [Commr. Rule 260.102.1(b)]

(b) [3:391] **Warning that agreement contingent:** The preincorporation subscription agreement must contain substantially the following provision:

"The sale of the securities that are the subject of this agreement has not been qualified with the Commissioner of Financial Protection and Innovation and the issuance of the securities or the payment or receipt of any part of the consideration therefor prior to the qualification is unlawful, unless the sale of securities is exempt from qualification by Section 25100, 25102, or 25105 of the California Corporations Code. *The rights of all parties to this agreement are expressly conditioned upon the qualification being obtained, unless the sale is so exempt.*" [See Corps.C. § 25102(a) (emphasis added)]

➪ [3:392] ***PRACTICE POINTER:*** This language is *not* necessary if *both* the offer and sale of the securities are otherwise exempt—e.g., under Corps.C. § 25102(h) or (f).

(c) [3:393] **No transfer of funds or securities:** No part of the purchase price may be paid or received and none of the shares may be issued until the sale is qualified under the Corporate Securities Law (or some exemption from qualification is established). [Corps.C. § 25102(a)]

(d) [3:394] **Postformation compliance with CSL:** After the corporation is formed, it should move promptly to qualify the shares for issuance under the Corporate Securities Law, or to establish that such issuance falls within one of the exemptions provided by the Corporate Securities Law. *See* ¶ 5:200 ff.

1) [3:395] **Comment:** Compliance should be as prompt as possible. Although there is no statutory time limit, delay in qualifying the issue or establishing an exemption from qualification may lead the subscriber to revoke the offer to subscribe; *see ¶ 3:385*.

3. [3:396] **Close Corporations—Drafting Proposed Shareholders Agreement:** Since the shareholders agreement is an important ingredient to establishing a close corporation (*see ¶ 3:243*), it makes sense to negotiate and draft such agreement even prior to forming the corporation.

Without an acceptable agreement among the proposed shareholders, it may be a complete waste of time to form a close corporation. It therefore makes sense to address the financial and control problems *before* incorporating. The parties can enter into preincorporation subscription agreements (¶ 3:380 ff.) setting forth in detail the financial and control agreements, and specifying that the preincorporation agreements shall serve as the shareholders agreement. Or, alternatively, they can give their tentative approval to the terms of the proposed shareholders agreement which will be submitted to them after the corporation is formed and the shares are issued.

• ***FORM:*** Close Corporation Shareholders Agreement, *see Form 3:C*.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 3-G

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

G. Preincorporation Transactions by Promoters

1. [3:398] Enforceability By or Against Corporation
2. [3:399] Promoters' Personal Liability
 a. [3:400] Where other party agrees to look solely to corporation
 b. [3:401.1] Where all parties agree to substitute corporation as debtor ("novation")
  (1) [3:401.2] Compare—corporate ratification
 c. [3:401.3] Where operating de facto corporation?
  (1) [3:401.4] Requirements
  (2) [3:401.5] Effect of current statutes
   (a) [3:401.6] Filing articles creates de jure corporation
   (b) [3:401.7] Failure to file articles of incorporation
 d. [3:401.8] Where creditor estopped to deny corporate existence

[3:397] Frequently, promoters of a proposed corporation need or desire to enter into leases, contracts or commitments for property or services that will be required by the corporation *before* it has been incorporated. Examples: While the corporation is in the process of being organized, the promoters lease office or factory space on its behalf; or order telephone and computer equipment, stationery and supplies.

To what extent are the promoters' agreements for goods or services enforceable by or against the corporation after its formation? And, to what extent are the promoters *personally* liable if the corporation is not (or if the proposed corporation is never organized)?

1. [3:398] **Enforceability By or Against Corporation:** A contract negotiated on the corporation's behalf by its promoters may be enforced by the corporation after its formation—and, conversely, the corporation may be held liable under the contract—if it *ratifies or adopts* the contract. Express ratification typically occurs where the board of directors, by resolution, accepts the contract (*see* ¶ *4:449*). Adoption (or implied ratification) occurs where, e.g., the corporation institutes an action on the contract or, most commonly, the corporation accepts the benefits of the contract with knowledge of its terms. [See *El Rio Oils (Canada) Ltd. v. Pacific Coast Asphalt Co.* (1949) 95 CA2d 186, 192, 213 P2d 1, 5 (parties knew contract contemplated formation of corporation); *Smith v. Glo-Fire Co.* (1949) 94 CA2d 154, 160, 210 P2d 286, 290 (same); and *02 Develop., LLC v. 607 South Park, LLC* (2008) 159 CA4th 609, 612, 71 CR3d 608, 610—contract assigned to LLC before articles of organization were filed could thereafter be adopted or ratified (same principles apply to LLCs and corporations)]

2. [3:399] **Promoters' Personal Liability:** Whether or not the corporation is even organized, and whether or not it ratifies pre-incorporation contracts by its promoters, the promoters themselves remain personally liable on such contracts, except as provided below (¶ 3:400 ff.). The corporation was not yet in existence, so they cannot be excused from liability as agents of a disclosed principal. [See *Shell Oil Co. v. Hanchett* (1936) 18 CA2d 240, 243, 63 P2d 338, 339]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Nevertheless, the corporation should *indemnify* its promoters against any liability incurred under preincorporation commitments made on its behalf, even where it appears that the promoters are not personally liable (*see ¶ 3:400 ff.*). Typically, the board of directors will authorize such indemnification at the same time it ratifies preincorporation transactions (*see ¶ 4:450*).

a. [3:400] **Where other party agrees to look solely to corporation:** If the promoters *disclose* that they are negotiating on behalf of a corporation not yet in existence, and the other party agrees to look solely to that corporation after its formation, the promoters are *not* personally liable—even if the corporation is never formed. In such a case, there is really *no contract* at all prior to the corporation's formation; only a continuing offer to the corporation, when, as and if it is formed. The supplier or creditor is denied any right of recovery against the promoters personally under such circumstances. [See *MacDonald v. Arrowhead Hot Springs Co.* (1931) 114 CA 496, 501, 300 P 105, 107]

➪ [3:401] ***PRACTICE POINTER:*** Few contracting parties are willing to look solely to the credit of a proposed corporation, particularly where they are being asked to lease or sell property or to provide services beforehand. Most parties will demand personal guarantees from the promoters or principals (*see ¶ 2:48*). Consequently, unless they are dealing with an extremely naive supplier or lessor, the promoters of a start-up corporation are going to be personally liable for the performance of most contracts negotiated on behalf of the corporation—before or after its formation.

b. [3:401.1] **Where all parties agree to substitute corporation as debtor ("novation"):** Once a corporation is formed, promoters' liability for preincorporation commitments can be extinguished by *novation*—i.e., a *mutual agreement* between the creditor, corporation and promoters *to substitute* the corporation as debtor, thereby relieving the promoters of further liability. [Civ.C. §§ 1531, 1532; see *Chiarello v. Axelson* (1938) 25 CA2d 157, 159, 76 P2d 731, 733]

(1) [3:401.2] **Compare—corporate ratification:** As discussed above (*¶ 3:399*), corporate ratification does not itself relieve promoters of liability on preincorporation agreements. To the contrary, it creates additional liability by binding the corporation as well.

c. [3:401.3] **Where operating de facto corporation?** Where promoters have operated a business in good faith as a "corporation," yet failed fully to comply with statutory requirements for incorporation, courts have nevertheless recognized the business as a *de facto* corporation so as to shield the promoters from personal liability for its debts.

(1) [3:401.4] **Requirements:** Recognition as a *de facto* corporation requires a finding that those operating the business have (a) made a bona fide attempt to organize in *colorable compliance* with the statute, and (b) carried on business in good faith as a corporation ("exercise of corporate powers"). [See *Midwest Air Filters Pac., Inc. v. Finn* (1927) 201 C 587, 592-593, 258 P 382, 384-385; *Cooper v. Leslie Salt Co.* (1969) 70 C2d 627, 634, 75 CR 766, 770]

(2) [3:401.5] **Effect of current statutes:** However, current statutory provisions regarding the significance and effect of filing articles of incorporation appear to leave no room for courts to apply the *de facto* corporation doctrine. Hence, the doctrine appears to have *no practical application* in California today.

(a) [3:401.6] **Filing articles creates de jure corporation:** Present statutory provisions both simplify the required form and content of articles of incorporation (*see ¶ 4:1 ff.*) *and* recognize that a corporation's existence commences upon the filing of its articles. [Corps.C. § 200(c)] Moreover, for all purposes (other than an action by the state in *quo warranto*), a copy of the articles certified by the Secretary of State is *conclusive evidence* of valid corporate formation and *prima facie* evidence of its corporate existence. [Corps.C. § 209]

Accordingly, once the articles are filed—even if containing defects—the corporation is considered to exist … so that the "promoters" would not be personally liable for transactions in the "de jure" corporation's name and on its behalf (unless they fail to complete the corporate formation, which may cause a court to "pierce the corporate veil"; see discussion of "alter ego" liability, *¶ 2:50 ff.*).

(b) [3:401.7] **Failure to file articles of incorporation:** On the other hand, although there are no California cases directly on point, the failure to file articles probably negates "colorable compliance" with the statutory incorporation procedures, thereby precluding application of the *de facto* corporation doctrine … regardless of whether the failure occurred because the articles were never prepared, were executed but never transmitted to the Secretary of State (i.e., the attorney goofed), or were transmitted but never arrived.

(Even here, however, an estoppel may still apply to limit promoter personal liability; *see ¶ 3:401.8*).

d. [3:401.8] **Where creditor estopped to deny corporate existence:** Even where a defective corporation is not accorded *de facto* status, a creditor may still be *estopped* to deny its separate existence if (1) the creditor voluntarily conducted business

in reliance only on the "corporation's" credit, and (2) the promoters with whom the creditor dealt believed in good faith that a corporation existed. [See, e.g., *Burrows Shoe Co., Inc. v. Brotherton* (1930) 106 CA 162, 164, 288 P 879, 880; *Home Owners' Loan Corp. v. Gordon* (1939) 36 CA2d 189, 191, 97 P2d 845, 846]

Rationale: Holding promoters personally liable for a business's debts under such circumstances would bestow a pure windfall on the creditor and be inequitable.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 3-H

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

H. Other Preincorporation Steps

- 1. [3:402] Selecting Name for Corporation
  - a. [3:402.1] Same requirements for all entities
  - b. [3:402.2] Letters, numbers and symbols
  - c. Restrictions and guidelines
    - (1) Restrictions on use of certain words
      - (a) [3:403] "Bank," "trust," "industrial loan," "thrift company," etc.
      - (b) [3:403.1] "Credit union"
      - (c) [3:403.2] "Cooperative"
      - (d) [3:403.3] "Insurance," "assurance," "surety," etc.
      - (e) [3:403.4] "Olympic," "Paralympic," etc.
    - (2) [3:404] Ordinarily, name need not disclose corporate status
      - (a) [3:404.1] Close corporations
      - (b) [3:404.2] Social purpose corporations
      - (c) [3:404.3] Professional corporations
        - 1) [3:404.4] No exemption for members' names
    - (3) [3:405] Name "likely to mislead the public" barred
    - (4) [3:406] Name must be "distinguishable" in Secretary of State's records
      - (a) [3:406.1] "Deceptively similar" standard replaced
      - (b) [3:406.2] What names are distinguishable
      - (c) [3:406.3] What names are not distinguishable
        - 1) [3:406.4] Examples of names not distinguishable
        - 2) [3:406.5] Compare—addition/omission of space creates new word
    - (5) [3:407] No consent exemption
    - (6) [3:407.6] Compare—conflict with LLC, limited partnership or fictitious business name
  - d. [3:408] Clearing and reserving corporate name
    - (1) [3:410] Procedure for checking name availability
      - (a) [3:410.1] Priority Telephone Service
      - (b) [3:412] Compare—Web check of similar names
      - (c) [3:412.1] Cross-checking with other states
    - (2) [3:413] Procedure for reserving name
      - (a) [3:414.1] Certificate of name reservation
      - (b) [3:414.3] Name reservation *not* renewable
    - (3) [3:415.1] Caution

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2. [3:416] Selecting Initial Agent for Service of Process
3. [3:418] Selecting Incorporators and/or Initial Directors
a. [3:419] Number of incorporators
b. [3:420] Who may serve as incorporators
c. [3:421] Responsibilities of incorporators vs. directors
d. [3:424] Death, resignation or incompetency of incorporator or initial directors

1. [3:402] **Selecting Name for Corporation:** Articles cannot be completed until a name is chosen for the corporation. The choice is up to the client, of course, but there are some legal restrictions, as discussed below (¶ 3:403 ff.). Among other restrictions, a corporation cannot choose a name that the Secretary of State determines is "likely to mislead the public" (*¶ 3:405 ff.*), and the name must be "distinguishable in the records of the Secretary of State" from the name of any domestic or foreign corporation on file or reserved (¶ 3:406 ff.). [Corps.C. § 201(b); see also Corps.C. § 2601(b)(1) (SPCs)]

a. [3:402.1] **Same requirements for all entities:** As of 2021, all California entities (domestic and foreign corporations, limited partnerships, and limited liability companies) are subject to the same statutory naming requirements. [Corps.C. §§ 201(b), 2601(b)(1); *see* ¶ 3:403.3 ff., 3:406 ff.]

b. [3:402.2] **Letters, numbers and symbols:** Business entity names must use the English alphabet, Arabic numerals (0, 1, 2, 3, 4, 5, 6, 7, 8, 9), symbols listed in 2 CCR § 21002 (@, #, $, %, #, &, *, +, =), or a combination thereof. [2 CCR § 21000(a)]

c. Restrictions and guidelines

(1) Restrictions on use of certain words

(a) [3:403] **"Bank," "trust," "industrial loan," "thrift company," etc.:** The corporate name may *not* include the words "bank," "banker," "banking," "trust," "trustee," "industrial loan company," "investment and loan," "thrift company" or "thrift and loan" without a certificate of approval from the Commissioner of Financial Protection and Innovation (formerly the Commissioner of Business Oversight). [Corps.C. § 201(a); Fin.C. §§ 562, 18104; see also Corps.C. § 2601(a) (SPCs)]

(b) [3:403.1] **"Credit union":** Nor may the corporate name contain the words "credit union" or related words without a certificate of approval from the Commissioner of Financial Protection and Innovation. [Fin.C. § 14100(c)]

(c) [3:403.2] **"Cooperative":** The name may not use "cooperative," any abbreviation of "cooperative" or any similar word unless the corporation is incorporated under the Consumer Cooperative Corporation Law (Corps.C. § 12200 et seq.) or other law governing cooperative business associations. [Corps.C. § 12311(b)]

(d) [3:403.3] **"Insurance," "assurance," "surety," etc.:** The name must not create a false implication that the corporation is an insurer. The words "insurance," "reinsurance," "assurance" or "surety" in a name for a corporation that is not an insurer may be considered misleading unless accompanied by words such as "agency," "agent," "services" or "broker" that remove the implication that the corporation is an insurer. [2 CCR § 21003(d)]

If the corporation is an insurer, the Insurance Commissioner must approve the corporate name. [Corps.C. § 201.5]

(e) [3:403.4] **"Olympic," "Paralympic," etc.:** The consent of the United States Olympic Committee may be required if the name contains the words "Olympic," "Olympiad," "Citius Altius Fortius," "Paralympic," "Paralympiad," "Pan-American," "America Espirito Sport Fraternite" or any combination of these words (unless used in the business name before September 21, 1950). [36 USC §§ 220501(b)(4), 220506(a)(4),(d)(2); see *San Francisco Arts & Athletics, Inc. v. United States Olympic Committee* (1987) 483 US 522, 525-528, 107 S.Ct. 2971, 2975-2976]

➪ [3:403.5] ***PRACTICE POINTER:*** The Secretary of State will file articles of a corporation whose name contains, e.g., "Olympic" when part of an address, such as "1500 Olympic Boulevard Corp." However, there are no published guidelines on this point. If in doubt, check with the Secretary of State's office.

(2) [3:404] **Ordinarily, name need not disclose corporate status:** Except as stated below (¶ 3:404.1), the corporate name need *not* include or end with "Inc." or "Corp." or any other word indicating corporate status.

(a) [3:404.1] **Close corporations:** The rule is different for a *statutory* close corporation: Its name *must* contain the word "corporation," "incorporated," "limited" or an abbreviation of one of these. [Corps.C. § 202(a)]

(b) [3:404.2] **Social purpose corporations:** The name of a social purpose corporation *must* contain the words "social purpose corporation" or an abbreviation thereof. [Corps.C. § 2602(a); *see* *¶ 9:22*]

(c) [3:404.3] **Professional corporations:** Professional corporations are generally subject to the same naming requirements as other domestic and foreign corporations (¶ 3:402 ff.), but must also comply with any naming regulations or rules adopted by the government agency that regulates their profession. [See Corps.C. § 13409; *and* ¶ 2:250 ff.]

1) [3:404.4] **No exemption for members' names:** As of January 1, 2021, professional corporations are no longer exempt from Corps.C. § 201's naming requirements (¶ 3:402 ff.) if they use the name of someone who is, was or might be part of the professional practice being incorporated, such as a present, prospective, or former shareholder. [See Corps.C. § 13409]

(3) [3:405] **Name "likely to mislead the public" barred:** As stated above (¶ *3:402*), the Secretary of State will not file articles bearing a corporate name "likely to mislead the public" (Corps.C. § 201(b))—i.e., a name creating a *false implication* the corporation is:

• *Affiliated with the government* by (i) using the recognized name or abbreviation of a city, county, state, country, region or recognized subdivision within a state or country, *and/or* (ii) including a word that commonly denotes governmental organization or authority, such as "Agency," "Commission," "Department," "Bureau," "Division," "Municipal" or "Board." [2 CCR § 21003(a)]

• A *professional corporation* by using "Professional Corporation," "P.C." or a similar designation, if the corporation is in fact *not* a professional corporation. [2 CCR § 21003(b)]

• A *noncorporate entity* by using a designation such as "LLC" or "LP" (but "Limited" or "Ltd." is acceptable). [2 CCR § 21003(c); see 2 CCR § 21001(c)(1)]

• An *insurer* (but the addition of "agency," "agent," "services" or "broker" may dispel the false implication). [2 CCR § 21003(d)]

(4) [3:406] **Name must be "distinguishable" in Secretary of State's records:** A corporation's name must be "distinguishable in the records of the Secretary of State" from the names of other domestic and foreign corporations, including names that are "under reservation." [Corps.C. § 201(b); *see* ¶ 3:406.2 ff.] The corporation's name must be "distinguishable" from:

• the name of any domestic corporation;

• the name of any foreign corporation authorized to transact intrastate business in the state;

• a name under reservation for another corporation;

• a name registered by a foreign corporation under Corps.C. § 2101;

• an alternate name of a foreign corporation under Corps.C. § 2106(b); and

• a name that will become a domestic or foreign corporation's name under a corporate instrument filed with the Secretary of State that has a delayed effective or file date. [Corps.C. § 201(b)]

The "distinguishable in the records of the Secretary of State" standard also applies to naming limited liability companies (Corps.C. § 17701.08(b)) and limited partnerships (Corps.C. § 15901.08(d)).

(a) [3:406.1] **"Deceptively similar" standard replaced:** The "distinguishable in the records of the Secretary of State" standard (¶ 3:406) replaces the preexisting standard that barred the Secretary of State from filing articles of incorporation if the corporation's name was "the same as, or resembles so closely as to tend to deceive," the name of another corporation. [See 2020 Cal. Legis. Serv. Ch. 361 (S.B. 522)]

(b) [3:406.2] **What names are distinguishable:** Subject to enumerated exceptions (¶ 4:406.3 ff.), a proposed name is distinguishable in the records of the Secretary of State from an existing name "when it is not the same as an existing name" and it "contains one or more different letters or numerals or has a different sequence of the same letters or numerals that is plainly recognizable by means of sight by the Secretary of State or a designee of the Secretary of State." [2 CCR § 21004(a)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [3:406.3] **What names are not distinguishable:** A proposed name is *not* distinguishable in the records of the Secretary of State from an existing name if the names are the same or differ only in one or more of the following ways:

• the existence or absence of business entity identifiers;

• the use of upper case, lower case, superscript or subscript letters or numerals;

• the addition or omission of distinctive lettering or typeface, punctuation, symbols, or spaces; or

• the use of an ampersand (&) in place of the word "and" or vice versa. [2 CCR § 21004(b)(1)-(4); see 2 CCR § 21001(f) (defining "punctuation"), § 21001(g) (defining "symbols")]

1) [3:406.4] **Examples of names not distinguishable:** The following names are not distinguishable:

• A B C Corps., AB C Corp., A.B.C. Corps. and A-B-C Corp.;

• Good Time Rest Home, LLC and Goodtime Rest Home LLC; and

• D.R.E.A.M. Incorporated and Dream Corporation. [2 CCR § 21004(b)(3)]

2) [3:406.5] **Compare—addition/omission of space creates new word:** Notwithstanding the above examples (¶ 4:406.4), a proposed name might be distinguishable from an existing name if the addition or omission of a space (or spaces) in the proposed name creates a new word (or words) that has a different meaning—e.g., Got Ham LP is distinguishable from Gotham, LP. [2 CCR § 21004(b)(5)]

(5) [3:407] **No consent exemption:** As of January 1, 2021, a corporation can no longer rely on an exception that would have allowed it to adopt a name that is substantially similar to another corporation's name if the other corporation provided its consent and the Secretary of State determined that the name is unlikely to mislead the public. [See Corps.C. §§ 201(b), 2601(b)(1)]

[3:407.1 - 3:407.5] ***Reserved.***

(6) [3:407.6] **Compare—conflict with LLC, limited partnership or fictitious business name:** The Secretary of State houses corporations, limited partnerships and LLCs in separate databases, and does not cross-check against the LLC or limited partnership databases when searching corporate names. Thus, a corporation could adopt a name that is identical (other than the "LLC" designation required for LLC names per Corps.C. § 17701.08(a)) to that of an existing LLC or limited partnership organized (or registered) in California.

A rudimentary search of similar LLC or limited partnership names may be made using Business Search (¶ 3:412). However, the only sure way to avoid selecting a corporate name that is confusingly similar to an existing LLC or limited partnership name is to request a separate name availability check for that name as an LLC or limited partnership.

Also, an available corporate name may be confusingly similar to a fictitious business name. Counsel may wish to perform a search of fictitious business names filed in the local county clerk's office. *See ¶ 2:8*.

d. [3:408] **Clearing and reserving corporate name:** To avoid false starts and wasted expense, you should make sure the corporate name is available, and then reserve the name, before drafting the articles of incorporation or ordering corporate kits or other supplies bearing the corporate name. (Often, even names that would seem too unusual to have been taken by any other corporation are already on file.)

[3:409] ***Reserved.***

(1) [3:410] **Procedure for checking name availability:** The availability of any corporate name can be checked preliminarily by writing to (or appearing in person at) the Secretary of State's Office, Name Availability Unit, 1500 11th Street, 3rd Floor, Sacramento, CA 95814. A name availability inquiry form may be viewed, filled in and downloaded from the Secretary of State's website (*www.sos.ca.gov*). There is no charge for this service.

(a) [3:410.1] **Priority Telephone Service:** Persons who establish a *prepaid* account through the Secretary of State's Priority Telephone Service (minimum deposit of $100) can check the availability of corporate names by telephone for a fee of $4 for each name search.

Attorneys who regularly seek name availability information should consider this service. For further information or to set up an account, contact the Secretary of State's Fiscal Office at (916) 653-1233 or email the Prepaid Accounts Staff through the Secretary of State's website (*www.sos.ca.gov*).

➪ [3:411] ***PRACTICE POINTERS:*** Ask the client to give you a list of several acceptable names, in order of preference. There is a limit of three names per inquiry letter when checking availability by mail, and several attempts may be required before an available name is obtained.

Also, bear in mind that this is only a *preliminary* check. A final name availability determination is made only when the articles are submitted for filing, at which time the Secretary of State can still reject the name (unless it was reserved by you or your client). [See 2 CCR § 21006(b)]

(b) [3:412] **Compare—Web check of similar names:** The Secretary of State's website (*www.sos.ca.gov*) contains a feature known as Business Search, which permits anyone to obtain basic information about a corporation (corporate number, status, address, agent for service of process). A rudimentary name availability search may be performed by inserting a corporate name. A searched name that is the same as the name of an active corporation will not be available. But even if no active corporation by that or a "confusingly similar" name appears, the name might still be unavailable: Unlike a name availability search, this feature does *not* track name reservations (*¶ 3:413*) or certain documents in the Secretary of State's office that await filing and that contain names of new corporations, such as articles of incorporation or qualifications of foreign corporations to do business in California.

(c) [3:412.1] **Cross-checking with other states:** In addition to clearing name availability in California, counsel should also make sure the desired name is available in *any other state in which the corporation may be required to qualify to do business* (*see ¶ 4:527*). (Such qualification may be refused if the corporation's name is likely to mislead the public or if the name is indistinguishable from other corporate names on file or reserved; see, e.g., Corps.C. § 201(b), *and* ¶ 3:406 ff.) Also check the relevant out-of-state statutes: Unlike California, some states require the name to include a corporate designation, such as "Inc.," "Corp." or "Ltd." (*¶ 3:403 ff.*) and may impose other requirements (see, e.g., Delaware General Corporation Law, 8 Del.C. § 102(a)(1); *compare ¶ 3:402 ff.*).

(2) [3:413] **Procedure for reserving name:** An available name may be reserved for a period of up to 60 days. A name reservation request form may be viewed, filled in and downloaded from the Secretary of State's website (*www.sos.ca.gov*), and mailed to the Secretary of State's Office, Name Availability Unit, at the address stated above (¶ 3:410). (Alternatively, subscribers to the Priority Telephone Service (¶ 3:410.1) may reserve the name by telephone.) In addition to other applicable charges, there is a $10 fee for each reserved name. [Corps.C. § 201(e); Gov.C. § 12186(a); see also Corps.C. § 2601(c) (SPCs)]

An available name may also be reserved in person at the Secretary's headquarters in Sacramento or at the Secretary's branch office in Los Angeles (300 S. Spring St., Room 12513 (213-897-3062)). A special nonrefundable handling charge is made for each name reservation handled "over-the-counter," in addition to the fee for reserving the name.

[3:414] ***Reserved.***

(a) [3:414.1] **Certificate of name reservation:** Upon payment of the appropriate fees, the Secretary of State will issue a *certificate* reserving the designated name(s) for the 60-day period. [Corps.C. § 201(e); see also Corps.C. § 2601(c) (SPCs)]

➪ [3:414.2] ***PRACTICE POINTER:*** When submitting the articles of incorporation, *include a copy of the name reservation certificate*. Otherwise, the Secretary of State may "bounce" the articles on the ground the name is taken … not realizing it was you who took it.

(b) [3:414.3] **Name reservation *not renewable:*** The 60-day reservation period is not extendable; and no two certificates can be issued to the same applicant or for use by the same people. [Corps.C. § 201(e); see also Corps.C. § 2601(c) (SPCs)]

➪ [3:415] ***PRACTICE POINTER:*** Although you cannot renew your reservation beyond the 60-day period, if you allow one business day to elapse thereafter, you can file a *new request* to reserve the same name. As long as no one else has applied during that one-day interim, you will be able to obtain a new 60-day certificate reserving the name.

(3) [3:415.1] **Caution:** The filing of articles of incorporation with the Secretary of State (or a fictitious business name statement with a county clerk) does not itself authorize the use of a name which others have a prior right to use (e.g., under trade name, state or federal trademark, or fictitious name laws, or common law). [Bus. & Prof.C. §§ 14417, 14418]

2. [3:416] **Selecting Initial Agent for Service of Process:** The articles of incorporation must state "[t]he name and street address in this state of the corporation's initial agent for service of process …" [Corps.C. § 202(c); see Corps.C. § 2602(c) (SPCs)]

The purpose of this requirement, of course, is to facilitate service of process upon the corporation. Service of summons and complaint upon an authorized agent constitutes service on the corporation, regardless of where it has its principal office, and even though none of its officers are within the state. [CCP § 416.10(a); see *National Equip. Rental Ltd. v. Szukhent* (1964) 375 US 311, 316, 84 S.Ct. 411, 414; *Pulte Homes Corp. v. Williams Mechanical, Inc.* (2016) 2 CA5th 267, 274, 206 CR3d 244, 250]

➪ [3:417] ***PRACTICE POINTERS:*** Various corporations are in the business of acting as agents for service of process for other corporations, and usually charge only a modest fee for this service. The advantage of naming a corporate agent for service of process is that it assures continuity and protects against the risk involved where the person designated as agent is no longer with the company (*see ¶ 4:27.3*).

As a practical matter, however, most small corporations designate one of their own officers or directors as agent for service of process, and show the corporation's business address as the address at which such agent may be served. This affords some assurance the corporation will receive prompt notice of any action filed against it.

Sometimes, the attorney is asked by the clients to serve as initial agent for service of process. The attorney may certainly do so but should be aware that accepting such agency carries with it the responsibility of exercising reasonable care to notify the client promptly of service upon the attorney. Such responsibility may be acceptable if there is an ongoing relationship with the clients, but otherwise may be a source of inconvenience to the attorney, with no assurance of compensation. The attorney's duty may become especially problematic where the corporation has dissolved and the former officers or directors cannot be readily located. [See *Pulte Homes Corp. v. Williams Mechanical, Inc.* (2016) 2 CA5th 267, 276-277, 206 CR3d 244, 251-252 (*discussed at ¶ 8:1007.1*)]

3. [3:418] **Selecting Incorporators and/or Initial Directors:** The articles of incorporation *may* set forth (optional) the names and addresses of the persons appointed to act as initial directors. In such event, each of those persons must sign and acknowledge the articles of incorporation. [Corps.C. §§ 200(b), 204(c); see also Corps.C. §§ 2600(b), 2603(c) (SPCs)]

More commonly, the articles do *not* name the initial directors. Instead, the articles are signed by persons who serve simply as *incorporators*—and who may or may *not* have any ongoing relationship with the corporation (i.e., the incorporators do not have to be the real organizers of the corporation).

a. [3:419] **Number of incorporators:** Only a single incorporator is required. The Code provides that "one or more" persons may form a corporation. [Corps.C. § 200(a); see also Corps.C. § 2600(a) (SPCs)]

b. [3:420] **Who may serve as incorporators:** Any one or more natural persons, or *partnerships* or *corporations* (domestic or foreign) may serve as incorporators of a California corporation. [Corps.C. § 200(a); see also Corps.C. § 2600(a) (SPCs)]

c. [3:421] **Responsibilities of incorporators vs. directors:** If the articles name the initial directors, it is up to them, after the articles are filed, to proceed promptly to complete the organization of the corporation; i.e., to hold an organizational meeting, adopt bylaws, elect officers, issue stock, etc.

If the initial directors are *not* named in the articles (the usual case), the *incorporators* have much the same powers and responsibilities until the directors are elected—i.e., the incorporators have the power to do "whatever is necessary and proper to perfect the organization of the corporation." This includes the power to amend the articles, *adopt bylaws* (which may, among other things, fix the number of directors), and *elect* the initial *directors* of the corporation. Only after these directors have been appointed and have accepted their office does the role (and responsibility) of the incorporators terminate. [Corps.C. §§ 210, 901, 906; *see ¶ 4:398*]

➪ [3:422] ***PRACTICE POINTER:*** Often, for sake of convenience, the attorney or someone in the attorney's office, will serve as incorporator. This facilitates execution and filing the articles (particularly if, for some reason, the articles are rejected by the Secretary of State's Office or some amendment is required).

However, many experienced lawyers recommend *against* this practice. The reason is that until the initial board of directors is elected, the incorporators have full responsibility for the corporation. If, for any reason, the clients end up in a disagreement as to the future of the corporation, the attorney who serves as incorporator often will be "in the middle" and subjected to conflicting demands as to what is to happen to the corporation (e.g., whom to appoint as initial directors, etc.).

➪ [3:423] ***PRACTICE POINTER:*** Another risky situation is to have *less than all* of the clients act as incorporators. As stated above (¶ 3:419), only one incorporator is needed, but this can cause problems.

For example, suppose A and B are advancing the money to form the corporation, but C, who has no money in the deal, is selected as the sole incorporator. Then, after the corporation is formed, the three of them have a falling out. C instructs the attorney to complete the corporate formation one way; whereas A and B (who have been paying the organizational expenses) direct the attorney to take other action. Technically, C, as the sole incorporator, has the power to complete the organization as C chooses.

This problem can be avoided *by having all of the clients sign as incorporators*. (A countervailing consideration, however, is that where there are numerous such clients, there may be considerable inconvenience in obtaining their signatures on the same set of original articles of incorporation; see Corps.C. § 200(b).)

d. [3:424] **Death, resignation or incompetency of incorporator or initial directors:** If a corporation has not issued shares and all of the directors resign, die or become incompetent, or if a corporation's initial directors have not been named in the articles and all of the incorporators die, resign or become incompetent before electing the initial directors, the superior court may appoint directors upon application by any party in interest. [Corps.C. § 306]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 3:A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

Forms

[Form 3:A] Voting Trust Agreement

VOTING TRUST AGREEMENT

THIS AGREEMENT is entered into and effective this _____ day of _____, between and among the following persons all of whom are shareholders of XYZ CORPORATION, a California corporation:

(such persons being the persons sometimes hereinafter referred to as "shareholders"); and
(such persons or entities being sometimes hereinafter referred to as "trustees").

1. EXCHANGE OF SHARES FOR VOTING TRUST CERTIFICATES: Simultaneously with the execution of this Agreement, the shareholders shall deliver to the trustees properly endorsed certificates for the number of shares of XYZ common stock shown opposite their respective names below. The trustees shall hold the shares transferred to them in trust, subject to the terms of this Agreement. The shareholders shall have no right to withdraw their shares prior to termination of this Agreement as hereinafter provided.

   The trustees shall cause the said shares to be transferred to them on the corporation's books and records. The trustees shall thereupon issue and deliver to each of the shareholders voting trust certificates, in the form shown in Exhibit A to this Agreement, for the number of shares so transferred, subject to satisfying any applicable qualification requirements under the California Corporate Securities Law.

2. TRUSTEES' POWERS, DUTIES AND COMPENSATION: The number of trustees under this Agreement shall be three (3). Action taken by a majority of them constitutes action by the trustees under this Agreement. The trustees may also serve the corporation as officers or directors, or in any other capacity, and may be certificate holders under this Agreement. The trustees shall have all of the rights, privileges and powers of a shareholder of XYZ Corporation, subject to the limitations set forth below:

a. Voting rights: During the existence of this trust, the trustees shall have the sole and exclusive right to vote the shares transferred to them. They may exercise such right in person or by proxy at all shareholder meetings and in all proceedings in which the vote or consent of shareholders is or may be required by the articles of incorporation or bylaws of XYZ Corporation, or as a matter of law.

   With respect to the election of XYZ directors, the trustees shall exercise such voting rights as they determine in the sound exercise of their discretion.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

As to all other matters of any character whatsoever on which a shareholder vote or approval is required by the articles or bylaws of the corporation or as a matter of law, or which is submitted to the shareholders for approval, the trustees shall vote the shares only in accordance with the prior written instructions, consent or vote on each such matter by holders of voting trust certificates representing not less than [a majority] [two-thirds] of the beneficial interests under this trust.

b. Notices, dividends and distributions: The trustees shall forward to each voting trust certificate holder copies of all notices, reports, statements and other communications received from XYZ Corporation. The trustees shall distribute, promptly upon receipt, all dividends and other payments or distributions received from XYZ Corporation, to the certificate holders in proportion to their respective interests. If any dividends consist of additional shares having voting rights, the trustees shall hold these shares in trust subject to the terms of this Agreement, and shall issue new voting trust certificates representing the additional shares to the certificate holders in proportion to their beneficial interests, subject to qualification if required under the California Corporate Securities Law.

c. No right to sell shares: The trustees shall have no authority to sell, pledge, hypothecate, encumber or otherwise dispose of the shares transferred to them under this Agreement, or received from the corporation by way of stock split or stock dividend.

d. Compensation of trustees: The trustees shall receive no compensation for their services under this Agreement except reimbursement for expenses reasonably and necessarily incurred in performing their duties hereunder. However, this paragraph shall not affect the right of any trustee to compensation from the corporation for services performed on its behalf in some other capacity (as officer, director, employee or otherwise).

e. Liability of trustees: The trustees, and each of them, shall not be liable for any error of judgment or mistake of fact or law, or for any action or omission under this Agreement, except for each trustee's own wilful misconduct or gross negligence. No trustee shall be liable for actions or omissions of any other trustee or trustees, or for actions or omissions of any employee or agent of any other trustee or trustees. The trustees may consult with legal counsel, and any action or omission undertaken by them in good faith in accordance with the opinion of legal counsel shall be binding and conclusive on the parties to this Agreement.

f. Replacement of trustees: Any trustee may be removed from office by the vote of holders of voting trust certificates representing at least [a majority] [two-thirds] of the beneficial interests. In case of a trustee's death, resignation or inability to act, the remaining trustees shall appoint a successor. If there are no incumbent trustees, the holders of voting trust certificates representing at least [a majority] [two-thirds] of the beneficial interests shall elect successor trustees.

3. TERMINATION: Unless extended as provided below, this Agreement shall terminate automatically ten (10) years after its effective date, or earlier by written instructions, consent or vote of holders of voting trust certificates representing [a majority] [two-thirds] of the beneficial interests.

As soon as practicable after termination, the trustees shall deliver to the certificate holders of record share certificates representing the number of shares owned by each holder, properly endorsed for transfer, and certificate holders shall surrender to the trustees their voting trust certificates properly endorsed. Any expenses incurred in connection with the said transfers shall be paid or reimbursed to the trustees by the shareholders. If any voting trust certificate holder fails or refuses to surrender his or her certificate, or cannot be located, the trustees may deliver the share certificates due that holder to the Secretary of XYZ Corporation, for the benefit of said person or persons, and upon so doing shall be fully discharged with respect to those share certificates.

4. EXTENSION: The term of this Agreement as stated in the preceding paragraph may be extended for an additional term of up to ten (10) years by written agreement of one or more of the certificate holders entered into within two (2) years before the expiration of the original term, if the trustees consent in writing to such extension. Successive extensions of this Agreement may be effected in the same manner. Any certificate holder who does not agree to the extension shall have the right to return of his or her share certificate at the expiration of the current term, in accordance with the procedures described in the preceding paragraph.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

5. FILING, INSPECTION RIGHTS: A duplicate of this Agreement and of any extension Agreement as provided in the preceding paragraph shall be filed with the Secretary of XYZ Corporation and shall be open for inspection of the same conditions as the corporation's record of shareholders.

6. FINCEN: Each Shareholder shall provide to the Trustees all information regarding such Shareholder as the Trustees may request in order to complete any filings required to be made with the Financial Crimes Enforcement Network and shall update such information as may be required from time to time.

IN WITNESS WHEREOF, the parties have executed this Agreement on the date hereinabove set forth.

SHAREHOLDERS	NUMBER OF SHARES TRANSFERRED
....	....
....	....
....	....

TRUSTEES

____

____

____

EXHIBIT "A"
VOTING TRUST CERTIFICATE

Certificate No. _____

This certifies that the undersigned have received from ____________ _____ share certificates representing _____ shares of the common stock of XYZ CORPORATION, a California corporation, designated above. This further certifies that the undersigned hold such share certificates as trustees subject to the terms and conditions of a Voting Trust Agreement dated _____ between and among various shareholders of said corporation and the undersigned as trustees, a copy of which is on file with the Secretary of said corporation.

During the term of said Voting Trust Agreement, and subject to its terms and conditions, the holder of this certificate shall be entitled to all dividends and distributions and all other economic benefits attributable to the share certificates transferred.

This Voting Trust Certificate is transferable by the holder. A new Certificate shall be issued to any transferee only when this Certificate, properly endorsed by the holder designated above, is surrendered to the undersigned trustees.

Upon termination of the said Voting Trust Agreement, and subject to its terms and conditions, the undersigned trustees will deliver to the holder of this Certificate share certificates representing the number of shares designated above, on surrender to the trustees of this Certificate, properly endorsed by the holder, together with payment of a sum sufficient to cover any expenses relating to transfer and delivery of said share certificates.

Dated: ____________

TRUSTEES

____

____

____

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 3:B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki ‘Vicki’ Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

Forms

[Form 3:B] Buy-Out Agreement

BUY-OUT AGREEMENT BETWEEN XYZ CORPORATION AND ITS SHAREHOLDERS

THIS AGREEMENT is made and entered into on ___________, among and between ___________, ___________, ___________, and ___________, (“Shareholders”), and XYZ Corporation, a California corporation (“Company”) with respect to all of the Company's capital shares now or hereafter outstanding, for the purpose of protecting the Company and the Shareholders in the event of a purchase, or other occurrence affecting the ownership of such shares, as provided for in this Agreement. The Shareholders collectively own all of the Company's outstanding shares, as follows:

SHAREHOLDER	NUMBER OF SHARES
___________	___________
___________	___________
___________	___________

IT IS HEREBY AGREED:

1. **RESTRICTIONS ON TRANSFER OF SHARES**

Except as may specifically otherwise be permitted below, no Shareholder shall transfer, in any way encumber or hypothecate, or otherwise dispose of any of his/her shares or any right or interest in them without obtaining the prior written consent of the Company and all other Shareholders, UNLESS the Shareholder shall first have given written notice to the Company of his/her intention to do so. Such notice shall be given as provided in paragraph 13 below and shall be accompanied by a true and correct copy of the agreement of sale entered into by the Shareholder and the proposed transferee. Promptly on receipt of such notice, the Secretary of the Company shall forward a copy of the notice and the agreement of sale to each member of the Company's board of directors, and within twenty (20) days thereafter a meeting of the board of directors shall be duly called, noticed and held to consider the proposed transfer. For forty-five (45) days following the notice to the Company, it shall have the option to purchase the shares, or such part of the shares as it may lawfully purchase, at the price and on the terms and conditions stated in the agreement. The Company's right to exercise its option and to purchase the shares is subject to the restrictions imposed on a corporation's repurchase of its own shares imposed by California Corporations Code Sections 500-503 and any other applicable governmental restrictions as may then be effective.

If the Company exercises the option within such forty-five (45) day period, the Secretary of the Company shall promptly give notice of that fact to the offering Shareholder and the Company shall pay the purchase price and complete the purchase in accordance with the terms of the sale to the proposed transferee.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

If the option is not exercised by the Company as to all shares set forth in the notice of intention to transfer within the forty-five (45) day period, then notice of the proposed transfer, in the same form as given to the Company, shall be given immediately by the Company to all other Shareholders, who shall have the option to purchase any (but not less than all) shares not purchased by the Company at the price and on the same terms and conditions as specified in the notice. Within twenty (20) days after such notice has been given, any Shareholder desiring to acquire any part or all of the shares offered shall deliver to the Company's Secretary a written election to purchase the number of shares specified therein. If the total number of shares specified in the election exceeds the number of offered shares, each Shareholder shall have priority, up to the number of shares specified in his/her election, to such proportion of the offered shares as the number of the Company's shares that he or she holds bears to the total number of the Company's shares held by all electing Shareholders. The shares not purchased on such a priority basis shall be allocated in one or more successive allocations to those Shareholders electing to purchase more than the number of shares to which they have a priority right, up to the number of shares specified in their respective elections, in the proportion that the number of shares held by each of them bears to the total shares held by all of them.

Within ten (10) days after the time for shareholder elections to purchase has expired, the Secretary of the Company shall notify each Shareholder of the number of shares as to which his/her election was effective, and each such shareholder shall pay the price and otherwise complete the terms and conditions of the purchase within ten (10) days thereafter.

If the Company and the Shareholders do not exercise their options to purchase ALL of the shares set forth in the notice of intention to transfer, within the time limits set forth above, then the offering shareholder may, at his/her option, sell to the Company and the Shareholders such shares as they have respectively elected to purchase, and dispose of the remainder in accordance with the terms specified in the notice, or transfer all of the shares in accordance with the terms specified in the notice, any time up to, but not after one hundred eighty (180) days from the date of such notice. No transfer of the shares shall be made after the end of the one hundred eighty (180) day period, nor shall any change in the terms of transfer from those set forth in the notice of intention to transfer be permitted without giving a new notice of intention to transfer and compliance with the procedures and requirements set forth above.

2. OBLIGATIONS OF TRANSFEREES

Each transferee or any subsequent transferee of shares of the Company, or any interest in such shares, shall hold such shares or interest in the shares subject to all of the provisions of this Agreement and shall make no further transfers except as provided in this Agreement.

3. PURCHASE ON DEATH

Within a period beginning with the death of any Shareholder and ending sixty (60) days following the death, the Company shall purchase and redeem all the decedent's shares of the Company's stock, at the price and on the terms provided in this Agreement.

If it is not legally possible for the Company to purchase the shares because it is unable to meet the tests contained in California Corporations Code Sections 500-503, the Company shall purchase as many shares as it is permitted to purchase under those Sections, and the surviving Shareholders shall purchase all the decedent's shares not purchased by the Company at the price and on the terms provided in this Agreement. The obligation of the surviving Shareholders to purchase shall be several and not joint and shall be proportionate to their respective shareholdings in the Company.

4. OPTIONAL PURCHASE ON OTHER EVENTS

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

In the event any Shareholder is adjudicated a bankrupt (voluntary or involuntary) or makes an assignment for the benefit of his/her creditors; or is physically or mentally incapacitated for more than six (6) months as shown by his/her inability to participate in the business; or his/her employment with the Company is terminated by him/her for any reason, or by the Company for cause, the Company and the remaining Shareholders shall have the option for a period of ninety (90) days following notice of any such event(s) to purchase all (but not less than all) of the shares owned by the Shareholder. Notice shall be given to the Shareholder or his representative in accordance with this Agreement. The option shall be exercisable first by the Company and thereafter by the remaining Shareholders, and the price and terms of purchase shall be as provided in this Agreement. If the Company does not elect to purchase all the shares and if notices of exercise from the remaining Shareholders specify in the aggregate more shares than are available for purchase by the Shareholders, each Shareholder shall have priority, up to the number of shares specified in his/her notice, to such proportion of those available shares as the number of the Company's shares he/she holds bears to the number of the Company's shares held by all Shareholders electing to purchase. The shares not purchased on such a priority basis shall be allocated in one or more successive allocations to those Shareholders electing to purchase more than the number of shares to which they have a priority right, up to the number of shares specified in their respective notices, in the proportion that the number of shares held by each of them bears to the number of shares held by all of them.

If the option created under this Paragraph 4 is not exercised as to ALL the shares owned by the Shareholder, he/she or his/her successor in interest will hold the shares not purchased free and clear of the provisions of this Section 4 but not the provisions of Section 1 of this Agreement.

5. **AGREED PRICE WITH ARBITRATION**

The purchase price to be paid for each of the shares subject to this Agreement shall be equal to the agreed value of the Company divided by the total number of shares outstanding as of the date the price is to be determined. The initial agreed value of the Company is _____, and on or before April 30 of each year hereafter, the parties to this Agreement shall review the Company's financial condition as of the end of the preceding fiscal year and shall determine by mutual agreement the Company's fair market value, which, if agreed on, shall be the Company's value until a different value is agreed on or otherwise established under the provisions of this Agreement. If the parties are able to reach mutual agreement, they shall evidence it by placing their written and executed agreement in the minute book of the Company.

If the last agreed valuation occurred more than two (2) years before the date of any event requiring determination of value under this Agreement, the value of a selling Shareholder's interest shall be agreed on by the selling Shareholder or his/her successor in interest and the Company. If they do not mutually agree on a value within thirty (30) days after the date of the event requiring the determination, the value of the selling Shareholder's interest shall be determined by arbitration as follows: The Company and the selling Shareholder or his/her successor in interest shall each name an arbitrator. If the two arbitrators cannot agree on a value, they shall appoint a third, and the decision of the majority shall be binding on all parties. Arbitration shall be in accordance with the rules of the [American Arbitration Association] [JAMS] as such rules shall be in effect at the time of arbitration.

6. **INSURANCE POLICIES**

In order to fund the payment of the purchase price for the shares to be purchased under this Agreement on the death of any Shareholder, the Company shall maintain in full force and effect a policy of life insurance on the life of each Shareholder in the face amounts shown in Exhibit “A” to this Agreement. Each such policy is listed and described in the exhibit, and any additional policies hereafter acquired for the same purpose shall also be listed in the exhibit. Each policy belongs solely to the Company which, as the owner of each policy, reserves all the powers and rights of ownership of it. The Company shall be named as the primary beneficiary of policies, and shall pay all premiums on them as they become due. No Shareholder shall have or exercise any of the powers of ownership of any of the policies.

7. **PAYMENT AND TRANSFER OF SHARES**

The purchase price to be paid for the shares under this Agreement shall be paid to the transferring Shareholder or his/her estate, as the case may be. If the event that leads to the purchase is the death of any Shareholder, the Company shall file the necessary proofs of death and collect the proceeds of any policies of insurance outstanding on the life of the deceased Shareholder as covered by this Agreement. The decedent's personal representative shall apply for and obtain any necessary court approval or confirmation of the sale of the decedent's shares under this Agreement. In all events, consideration for the shares shall be delivered as soon as practicable to the person entitled to it, and the certificates representing the purchased shares shall be properly endorsed and delivered to the Company for cancellation or transfer as appropriate. If the purchase follows the death of any Shareholder and the purchase price is more than the amount of insurance proceeds, if any, the purchaser or purchasers shall pay the purchase price in cash up to the full amount of the insurance proceeds, and shall pay the balance of the purchase price in cash.

8. **ADMINISTRATIVE APPROVALS**

The Company agrees to apply for, and use commercially reasonable efforts to obtain, all governmental and administrative approvals required in connection with the purchase and sale of shares under this Agreement. The Shareholders agree to cooperate in obtaining the approvals and to execute any and all documents that may be required to be executed by them in connection with the approvals. The Company shall pay all costs and filing fees in connection with obtaining the approvals.

9. **SHARE CERTIFICATES**

On execution of this Agreement, each Shareholder shall have placed on the certificates representing his/her shares the legend set forth in paragraph 10 below. None of the shares shall be transferred, encumbered or hypothecated, or in any way disposed of or alienated, except under and pursuant to the terms of this Agreement. Each Shareholder shall have the right to vote his/her shares and receive any dividends paid on them until the shares are sold or transferred as provided in this Agreement.

10. **LEGENDS ON SHARE CERTIFICATES**

Each share certificate, when issued, shall have conspicuously endorsed on its face the following words: “Sale, transfer, or hypothecation of the shares represented by this certificate is restricted by the provisions of a Buy-Out Agreement among the Shareholders and the Company dated _____, a copy of which may be inspected at the principal office of the Company, and all the provisions of which are incorporated by reference in this certificate.” A copy of this Agreement shall be delivered to the secretary of the Company, and shall be shown by the secretary to any interested person making inquiry about it.

11. **SHAREHOLDER WILLS**

Each Shareholder agrees to include in his/her Will a direction and authorization to his/her executor to comply with the provisions of this Agreement and to sell his/her shares in accordance with this Agreement; however, the failure of any Shareholder to do so shall not affect the validity or enforceability of this Agreement.

12. **MISCELLANEOUS MATTERS**

Each party to this Agreement agrees to perform any further acts and execute and deliver any documents that may be reasonably necessary to carry out the provisions of this Agreement. The provisions of this Agreement may be waived, altered, amended, or repealed, in whole or in part, only on the written consent of all parties to this Agreement. This Agreement shall be binding on, and shall inure to the benefit of, the parties to it and their respective heirs, legal representatives, successors, and assigns. It

is intended that each paragraph of this Agreement shall be viewed as separate and divisible, and in the event that any paragraph shall be held to be invalid, the remaining paragraphs shall continue to be in full force and effect. This Agreement shall be construed in accordance with, and governed by, the laws of the State of California.

13. **NOTICES**

All notices, requests, demands, and other communications under this Agreement shall be in writing and shall be deemed to have been duly given on the date of service if served personally on the party to whom notice is to be given, or within 72 hours after mailing, if mailed to the party to whom notice is to be given, by first-class mail, registered or certified, postage prepaid, and properly addressed to the party at his address set forth on the signature page of this Agreement, or any other address that any party may designate by written notice to the others.

14. **FINCEN**

Each Shareholder shall provide to the Company all information regarding such Shareholder as the Company may request in order to complete any filings required to be made with the Financial Crimes Enforcement Network and shall update such information as may be required from time to time.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

	XYZ Corporation (Company)
By ___________	By ___________
Secretary	President
SHAREHOLDERS:	
___________	___________
A	
___________	___________
Spouse of A	Address
___________	___________
B	
___________	___________
Spouse of B	Address
___________	___________
C	
___________	___________
Spouse of C	Address
___________	___________
D	
___________	___________
Spouse of D	Address

I, the above consenting spouse/registered domestic partner, acknowledge that I have read the foregoing Agreement and that I know its contents. I am aware that by its provisions my spouse/registered domestic partner agrees to sell all his/her shares of the Company, including my community interest in them, on the occurrence of certain events. I hereby consent to the sale, approve

of the provisions of this Agreement, and agree that those shares and my interest in them are subject to the provisions of this Agreement and that I will take no action at any time to hinder operation of the Agreement on those shares or my interest in them.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 3:C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 3. Preincorporation Planning

Forms

[Form 3:C] Close Corporation Shareholders Agreement

CLOSE CORPORATION

SHAREHOLDERS AGREEMENT

THIS AGREEMENT is entered into as of the ___________ day of ___________, by and between MANAGER ("Manager") and INVESTOR ("Investor"), as shareholders of Stores, Inc. a California statutory close corporation.

RECITALS

A. Manager and Investor are the owners of 25 and 75 shares respectively, of the capital stock of Stores, Inc., a California close corporation ("Stores"), which shares constitute all of the issued and outstanding shares of Stores.

B. Manager and Investor desire to become parties to and subject their shares of capital stock in Stores to a shareholders agreement as provided in Section 300 of the California Corporations Code.

NOW, THEREFORE, it is agreed as follows:

1. MANAGEMENT OF CORPORATION

Notwithstanding anything to the contrary contained in the Bylaws of Stores and except as required by the California Corporations Code, the business and affairs of Stores shall be managed and all corporate powers shall be exercised by or under the direction of Manager; provided, however, that Manager shall have no authority to do any of the following without the prior written consent of Investor:

(a) Issue or sell on behalf of Stores any additional shares of its capital stock;

(b) Sell all or substantially all of its assets; or

(c) Cause Stores to engage in any business other than that in which it is presently engaged.

No meetings of shareholders or directors need be held but may be called as provided in the Bylaws of Stores.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2. **BOARD OF DIRECTORS**

Manager and Investor are the sole directors of Stores, and agree that they or their respective designees shall constitute the sole directors of said corporation throughout the term of this Agreement. The board shall perform such functions as are not otherwise delegated to Manager or provided for under this Agreement.

3. **EMPLOYMENT OF MANAGER**

Manager shall be employed as the President and Chief Executive Officer of Stores, for a term of five (5) years, unless such employment is sooner terminated pursuant to the provisions of Paragraph 4 below. Manager shall receive an annual salary of $________ payable monthly; provided, however, that he may receive bonuses or additional compensation as may be authorized by the board of directors.

4. **TERMINATION OF EMPLOYMENT**

Manager's employment as President of Stores shall terminate upon the occurrence of any of the following events:

(a) The willful and persistent failure by Manager to perform Manager's duties and responsibilities under this Agreement;

(b) The voluntary resignation of Manager;

(c) The bankruptcy, death or physical incapacity of Manager;

(d) An order of a court of competent jurisdiction declaring Manager to be of unsound mind;

(e) Written notice of termination from Investor, if Manager is convicted of a felonious crime involving moral turpitude; or

(f) The involuntary dissolution of Stores as provided under applicable California law.

No other event shall constitute a cause for termination. In the event of the termination of Manager's employment by Stores, the corporation shall voluntarily wind up and dissolve.

5. **DIVIDENDS**

Subject to the limitations contained in Sections 500 and 501 of the California Corporations Code, Investor shall be entitled to receive each year from Stores as dividends an amount equal to $________ and such additional amount as may be authorized by the board of directors. Manager shall participate pro rata to his ownership of outstanding shares of Stores in any dividends declared by the board of directors under this section 5.

6. **ELIMINATION OF CUMULATIVE VOTING**

Notwithstanding the provisions of Section 708 of the California Corporations Code, Manager and Investor, as shareholders of Stores, elect to and hereby eliminate cumulative voting in the election of directors.

7. **TRANSFER RESTRICTIONS**

(INSERT HERE APPROPRIATE PROVISIONS FROM FORM 3:B—"BUY-OUT AGREEMENT")

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

8. **RECORDS AND REPORTS**

Manager shall cause Stores to maintain the books, records and other documents as required by Section 1500 of the California Corporations Code. Notwithstanding any waiver thereof contained in the Bylaws, Manager shall cause Stores to furnish to Investor an annual report referred to in Section 1501(a) of said Code, which report need not be audited.

9. **TERMINATION OF AGREEMENT**

This Agreement shall remain in effect until terminated by mutual agreement of the parties, or until Stores ceases to be a close corporation as defined in California Corporations Code Section 158. In the event of an original issuance of shares by Stores to a new shareholder who does not become a party to this Agreement, this Agreement shall nevertheless continue in full force and effect to the extent it is enforceable apart from the provisions of California Corporations Code Section 300(b).

10. MISCELLANEOUS

(a) This Shareholders Agreement shall inure to the benefit of and be binding upon the successors and assigns of the parties hereto.

(b) This Shareholders Agreement shall be governed by and construed in accordance with the laws of the State of California.

(c) A duplicate original of this Shareholders Agreement shall be filed with the Secretary of Stores for inspection by any prospective purchaser of shares of the capital stock of Stores.

(d) The share certificates of Stores shall bear the legend required by California Corporations code section 418(c), and also the following: “The shares represented by this certificate are subject to transfer and other restrictions as set forth in the Close Corporation Shareholders Agreement dated ___________.”

(The date of the within agreement).

IN WITNESS WHEREOF, the parties hereto have hereunto affixed their signature as of the day and year first above written.

....	....
MANAGER	INVESTOR

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. ¶ 4:1

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

[4:1] Overview

A corporation springs into existence when its articles are filed with the Secretary of State (*see ¶ 4:159*). But additional documentation and procedures are required to complete its organization … such as drafting and adopting bylaws, holding an organizational meeting of the board of directors, issuance of stock, etc. (Failure to complete the corporate organization may enable the corporation's creditors to "pierce the corporate veil" and assert claims against the entity's principals; *see ¶ 2:50 ff.*)

This Chapter focuses on the articles of incorporation and other formalities involved in organizing a corporation (except issuance of stock, which is covered separately in Chapter 5).

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 4-A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

A. Preparing the Articles of Incorporation

- 1. [4:3] Required Provisions ("Short Form" Articles)
  - a. [4:3.1] Form ARTS-GS
  - b. [4:4] Corporate name
  - c. [4:5] Statement of corporate purpose
    - (1) [4:9] Scope of powers conferred—"any lawful act or activity"
      - (a) [4:10] Specific powers enumerated by statute
      - (b) [4:11] Broadly construed
    - (2) [4:12] No additional statement of powers permitted in articles
      - (a) [4:13] Compare—former law
    - (3) [4:14] Option to limit corporation's purposes or powers
      - (a) [4:15] Examples
      - (b) [4:16] Drafting considerations
        - 1) [4:17] Where limitation should appear
        - 2) [4:18] Example
      - (c) [4:19] Limited powers no defense to actions by third parties
        - 1) [4:20] Examples
        - 2) [4:21] Corporation may enforce
      - (d) [4:22] Situations where limitations on corporate powers effective
      - (e) [4:22.5] Compare—SPCs
  - d. [4:23] Designation of initial agent for service of process
    - (1) [4:24] Natural person or corporate agent
    - (2) [4:25] Address of natural person
    - (3) [4:26] Changing agent for service of process
      - (a) Agent's resignation
        - 1) [4:27.1] Filing statement of resignation
        - 2) [4:27.2] Disclaimer of appointment
    - (4) [4:27.3] Compare—service of process on Secretary of State where no designated agent
  - e. [4:27.6] Corporation's street/mailing address
  - f. [4:28] Authorized capital (share structure)
    - (1) [4:29] Single class of shares
      - (a) [4:30] Name of class
      - (b) [4:32] Number of shares authorized
        - 1) [4:32.1] Comment

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2) [4:32.2] Caution—corporations doing business in other states
3) [4:33] Planning for future share issuances
(c) [4:34] Compare—number of shares to be issued
(2) [4:35] Several classes of shares
(a) [4:37] Designation of each class or series
1) [4:38] Class vs. series
(b) [4:39] Number of shares in each class or series
1) [4:39.1] Class of shares issuable in series
a) [4:39.2] Designation of series where no common stock
b) [4:39.3] Limitations on number of shares
c) [4:39.4] Board action to increase or decrease shares of series
(c) [4:41] Statement of rights, preferences, privileges and restrictions
1) [4:42] Particular rights, preferences, privileges and restrictions
a) [4:42.1] Protections required by Financial Protection and Innovation Commissioner
2) [4:43] Board may be authorized to determine
a) [4:45] Certificate of determination to be filed with Secretary of State
3) [4:45.1] Attributes may be made dependent on facts outside articles
(d) [4:46] No distinction exists unless stated or authorized in articles
(3) [4:47] "Par value" designation inappropriate
(a) [4:48] Compare—for tax and fee purposes
(b) [4:49] Compare—for securities law purposes
(c) [4:49.1] Compare—corporations qualified in other states
2. [4:50] Optional Provisions for Inclusion in Articles
a. [4:51] Purpose
(1) [4:52] Limitation—prohibited provisions
b. [4:53] Counsel's responsibility re optional provisions
(1) [4:54] Comment
c. [4:55] Whether to include in articles or bylaws
(1) [4:56] Approach
(2) [4:58] Reasons for *not* including in articles
(3) [4:59] Possible reasons for including in articles
d. [4:60.1] Reference to outside facts or documents
(1) [4:60.2] Application
(a) [4:60.3] Establish the rights, preferences, privileges…
(b) [4:60.4] Grant power to levy assessments…
(c) [4:60.5] Establish qualifications of persons who…
(d) [4:60.6] Impose super-majority shareholder voting requirements,…
(e) [4:60.7] Require that the shareholders, or…
(f) [4:60.8] Impose reasonable restrictions on transferability…
(g) [4:60.9] Grant preemptive rights to shareholders…
(h) [4:60.10] Limit the duration of the…
(i) [4:60.11] Restrict or limit the corporation's…
(j) [4:60.12] Grant debt holders voting rights…
(k) [4:60.13] Grant shareholders the right to…
(2) Special requirements as to referenced agreements
(a) [4:60.14] Shareholder approval of amendments
(b) [4:60.15] Copies must be maintained
e. [4:61] Particular optional provisions
(1) [4:62] Optional provision limiting corporate existence

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [4:63] Comment
(2) [4:64] Optional provision limiting powers of corporation
(3) [4:65] Optional provisions relating to directors
(a) [4:67] Designation of initial directors
1) [4:68] Must execute articles
(b) [4:70] Establishing number (or range) of directors
1) [4:72] Required minimum
2) [4:73] Authorizing fixed number
a) [4:73.1] Odd vs. even number of directors
b) [4:73.3] Comment
3) [4:74] Authorizing variable numbers of directors (“flexible board”)
a) [4:75] Example
b) [4:76] Caution—risk to minority shareholders
4) [4:77] Compare—limit on amendments reducing size of board
5) [4:77a] Special rules for “listed” corporations with staggered terms
a) [4:77b] Six-director minimum where two-year staggered terms
b) [4:77c] Nine-director minimum where three-year staggered terms
c) [4:77d] Compare—“*unlisted*” corporations may adopt staggered term provisions to take effect upon listing
d) [4:77e] Effect of “delisting” on staggered terms
e) [4:77j] Compare—“listed” golf and tennis corporations
1/ [4:77k] Board and shareholder approval requirement
(c) [4:77.1] Limiting directors' term to effect voting shift
(d) [4:78] Establishing qualifications for directors
1) [4:79] Example
2) [4:79.1] Independence requirements for directors of “listed” corporations
3) [4:79.2] Female director requirements for “listed” corporations
4) [4:79.3] Requirements for directors from underrepresented communities for “listed” corporations
(e) [4:80] Provisions for less-than-majority quorum
1) [4:81] Caution
2) [4:82] Compare—provisions for less than majority vote prohibited
(f) [4:83] Provisions for supermajority vote or quorum of directors
1) [4:84] Comment
(g) Filling vacancies on board
1) [4:86] Vacancy resulting from director's resignation or death
2) [4:87] Vacancy resulting from removal of director
(h) [4:88] Restricting power of directors to adopt, amend, or repeal bylaw provisions
(i) [4:88.1] Provisions limiting directors' liability
1) Limitations
a) [4:88.3] Not retroactive
b) [4:88.4] No insulation from direct shareholder actions
c) [4:88.5] Insulated only from monetary damages
d) [4:88.6] No insulation re highly culpable misconduct
e) [4:88.6a] No relief from liability under federal law
f) [4:88.7] Inapplicable to officers
(j) [4:88.8] Provisions authorizing expanded director indemnification
1) Limitations
a) [4:88.9] Egregious misconduct

b) [4:88.9a] Indemnification prohibited by statute
2) [4:88.10] Compare—SPCs
3) [4:88.11] Comment
(k) [4:88.13] Eliminating cumulative voting for directors—“listed” corporations only
1) [4:88.14] Limitation on removal of directors
2) [4:88.15] Compare—“*unlisted*” corporations may adopt such provision effective upon listing
a) [4:88.16] “Delisting” restores cumulative voting
(l). [4:88.20] Requiring director's election by majority vote in uncontested election—“listed” corporations without cumulative voting
1) [4:88.21] “Uncontested election”
2) [4:88.22] Expiration of term for incumbent director who fails to receive majority vote
3) [4:88.23] Comment
(m) [4:88.31] Staggered terms (mutual water company)
(n) [4:89] Other provisions regulating board procedures
(o) [4:91] Compare—*prohibited* provisions relating to directors
(4) [4:96] Optional provisions relating to shares
(a) [4:98] Shareholder qualification requirements
1) [4:99] Comment
2) [4:100] Compare—professional corporations
3) [4:101] Must be shown on share certificate
(b) [4:102] Shareholders' right to determine consideration for which shares may be issued
1) [4:103] Comment
(c) [4:104] Minimum price for which shares may be issued
1) [4:105] Comment
(d) [4:106] Shares subject to future assessment
1) [4:107] Comment
(e) [4:108] Preemptive rights
(f) [4:109] Redemption rights
(g) [4:109.5] Conversion rights
1) [4:109.6] Convertible at holder's option
2) [4:109.7] Convertible at corporation's option—“listed” corporations only
3) [4:109.8] Compare—conversion of debt securities
(h) [4:110] Reduced shareholder quorum
1) [4:111] Comment
2) [4:112] Compare—articles may not increase shareholder quorum requirements
a) [4:113] Exception
(i) [4:114] Shareholder action by more than majority
1) [4:115] Comment
2) [4:115.2] Limitations on supermajority amendments by corporations with 100 or more shareholders
a) [4:115.3] 66-2/3% ceiling
b) [4:115.4] Approval of amendment
c) [4:115.6] Exemption for “nonpublic” corporations with multiple classes of stock
1/ [4:115.6a] Comment
d) [4:115.7] Compare—pre-1989 super-majority provisions
3) [4:116] Matters not subject to super-majority approval requirement
a) [4:117] Election of directors
b) [4:118] Removal of directors

c) [4:119] Voluntary dissolution
(j) [4:120] More or less than one vote per share
(k) [4:121] Class voting for directors
(l). [4:122] Shareholder approval for particular board actions ("veto" power)
1) [4:123] Comment
2) [4:124] Drafting considerations
3) [4:125] "Shareholder approval"
4) [4:126] No effect on third parties dealing with corporation
(m) [4:127] Ban on shareholder action by written consent
(n) [4:128] Waiving certain statutory protections for preferred shares
(o) [4:129] Prohibiting reissuance of reacquired shares
1) [4:130] Effect—reduction of capital upon reacquisition
(p) [4:131] Transfer restrictions
1) [4:132] Restrictions must be "reasonable"
a) [4:133] Right of first refusal
b) [4:134] Right to purchase at fixed price
2) [4:135] No retroactive effect
3) [4:136] Must appear on share certificate
(q) [4:136.1] Shareholder buy-out provisions to govern upon dissolution
(r) [4:136.2] Blockchain technology for share issuance and transfers
1) [4:136.3] Compare—Delaware law
(s) [4:137] Compare—*prohibited* provisions relating to shares and shareholders
1) [4:138] Redemption of common stock
2) [4:139] Converting shares into debt
a) [4:139.1] Exception for "listed" corporations
3) [4:140] Eliminating shareholder approval as to certain transactions
4) [4:141] Changing shareholder quorum requirements
5) [4:142] Changing cumulative voting for directors
6) [4:143] Increasing vote required for voluntary dissolution
(5) [4:144] Optional provisions relating to debt holders (granting voting rights to debt holders)
(a) [4:145] Comment
(6) [4:145.1] Optional provisions authorizing expanded indemnification for corporate agents

[4:2] After preincorporation planning is completed, preparing and filing the articles of incorporation is the lawyer's responsibility.

Drafting articles ordinarily presents no problem where the corporate structure is relatively simple. Counsel may utilize "short form" articles, consisting only of the minimum provisions required by law (¶ 4:3 ff.).

But where the organizers desire a more complex financial and control structure, counsel may have to go beyond the minimum required provisions, and include additional provisions that are optional under the Corporations Code (¶ *4:50 ff.*). Such provisions often raise tax and securities laws considerations, as developed later in this Chapter.

1. [4:3] **Required Provisions ("Short Form" Articles):** The following provisions are required in every articles of incorporation. Articles containing only these provisions, and no others, are referred to as "short form" articles.

FORMS

• Articles of Incorporation ("Short Form"), *see Form 4:A*.

• The Secretary of State's office maintains the following "short form" articles that may be filled in and downloaded on its website (*www.sos.ca.gov*):

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

— Articles of Incorporation—General Stock (Form ARTS-GS)

— Articles of Incorporation—Close (Form ARTS-CL)

— Articles of Incorporation—Professional (Form ARTS-PC)

a. [4:3.1] **Form ARTS-GS:** The Secretary of State has created a form of articles of incorporation, Form ARTS-GS, which is available on the Secretary of State's website (*www.sos.ca.gov*); *see*¶ 4:160.1.

b. [4:4] **Corporate name:** The name of the corporation must be stated in the articles. [Corps.C. § 202(a); *see*¶ *3:402 ff.* re restrictions and guidelines on corporate name]

Normally, the name is set forth both in the heading (e.g., "Articles of Incorporation of XYZ Co.") and in the body ("1. The name of this corporation is XYZ Co.").

c. [4:5] **Statement of corporate purpose:** The articles must contain one of several permitted statements of purposes set forth in Corps.C. § 202(b):

• [4:6] **Ordinary corporations:** If it is an ordinary business corporation, the articles must state:

> "The purpose of the corporation is to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law of California other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code." [Corps.C. § 202(b)(1)(A)]

• [4:7] **Professional corporations:** If it is a professional corporation (*see*¶ *2:244 ff.*):

> "The purpose of the corporation is to engage in the profession of ___ (with the insertion of a profession permitted to be incorporated by the California Corporations Code) and any other lawful activities (other than the banking or trust company business) not prohibited to a corporation engaging in such profession by applicable laws and regulations." [Corps.C. § 202(b)(1)(B)]

(Articles of a professional corporation must also contain a specific statement that the entity is a professional corporation (¶ *2:248.1*).)

• [4:7.1] **Social purpose corporations (SPCs):** If the corporation is a SPC, the articles must contain the corporate purpose statement required of all SPCs (¶ 9:23). (In addition, the articles must contain a specific purpose statement (¶ 9:24) and a statement that the entity is a social purpose corporation (¶ 9:25).)

• [4:7.2] **Benefit corporations:** The articles of a benefit corporation must contain the corporate purpose statement required of all "ordinary" corporations (¶ *4:6*). (In addition, the articles must include a statement that the entity is a benefit corporation and must identify any specific public benefits to be pursued by the corporation (¶ *9:521 ff.*).)

• [4:8] **Banks, insurance companies:** If the corporation is subject to the Banking Law or Insurance Code, the articles must set forth a statement of purpose in accordance with those laws. [Corps.C. § 202(b)(2), (3)]

(1) [4:9] **Scope of powers conferred—"any lawful act or activity":** The phrase "any lawful act or activity" contained in the statements of purpose (¶ *4:6, 4:7*) confers upon a corporation all powers that *can* be conferred upon it without violating other laws. Basically, it confers all of the powers of a natural person in carrying on business activities. [Corps.C. §§ 206, 207; see also Corps.C. §§ 2604, 2605 (SPCs, ¶ *9:5*); Corps.C. § 14610(a) (benefit corporations, ¶ *9:505*)]

(a) [4:10] **Specific powers enumerated by statute:** This includes, without limitation, the following specific powers enumerated in the Code:

• To qualify to do business in any other state or country;

• To enter into partnerships, joint ventures or other associations, even if such arrangements involve delegating control of the business to others;

• To enter into contracts of any kind, including guaranties;

• To borrow money and secure credit by pledging corporate assets or placing liens thereon;

• To pay pensions and to maintain retirement plans, stock option plans and similar incentive programs for corporate employees;

• To make charitable contributions, regardless of specific corporate benefit. [Corps.C. § 207; see also Corps.C. § 2605 (SPCs)]

(b) [4:11] **Broadly construed:** Corporate powers are construed broadly. In the absence of limitation in the articles (¶ *4:14 ff.*), any act that would be lawful for a natural person is lawful for a corporation.

For example, absent a specific statute prohibiting political campaign contributions by corporations, a corporation has the power to make such contributions unless its articles specifically provide otherwise. [60 Ops.Cal.Atty.Gen. 348 (1977)]

(2) [4:12] **No additional statement of powers permitted in articles:** Since the prescribed statement of purpose clause ("any lawful act or activity") already confers upon the corporation all powers that can be conferred as a matter of law, no additional statement of powers is necessary; and indeed, would be improper. The Code specifically provides: "The articles shall *not* set forth any further or additional statement with respect to the purposes or powers of the corporation, *except by way of limitation* …" [Corps.C. § 202(b), last para. (emphasis added)]

(a) [4:13] **Compare—former law:** Prior to adoption of the above provision (¶ *4:12*), the practice was to include in the articles a boilerplate list of every conceivable purpose and power that the corporation might ever need. (The list usually occupied several pages and inevitably concluded with, "together with any other lawful purpose for which a corporation may now or hereafter be organized under the laws of the State of California.") Such boilerplate is no longer necessary; nor is it even permitted.

(3) [4:14] **Option to limit corporation's purposes or powers:** While the articles may not list additional powers, they *may* include provisions limiting or restricting the business in which the corporation may engage, or the powers it may exercise, or both. [See Corps.C. §§ 202(b) (last para.), 204(a)(6)]

(a) [4:15] **Examples:** The following are the most frequently encountered limitations on a corporation's powers or purposes:

• Prohibitions on engaging in specific business activities;

• Prohibitions on guaranteeing loans *unrelated* to the corporation's business;

• Prohibitions on *political campaign contributions*, or other *gifts* of corporate property;

• Prohibitions on becoming a general *partner* and assuming partnership obligations.

(b) [4:16] **Drafting considerations:** Unless the articles *clearly* provide otherwise, corporate powers are construed broadly by the courts. Consequently, if the organizers desire to limit the corporation's powers in some fashion, the limitation must be included in the articles, and must be drafted carefully. To assure that the limitation will be effective, the acts or powers to be restricted should be stated as specifically as possible.

1) [4:17] **Where limitation should appear:** To avoid doubt, the limitation should be included as *part of the statement of purpose clause*, or immediately thereafter.

2) [4:18] **Example:** For example, if the organizers desire to prevent the corporation from ever guaranteeing debts of a third party, the statement of purpose clause in its articles could be drafted as follows:

> "The purpose of the corporation is to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law of California, other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code; *except that* this corporation shall have *no* power to guarantee the debts, obligations or liabilities of any other person,

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

firm or entity, whether such debt, obligation or liability is related to the business of this corporation or otherwise."

➪ [4:18.1] ***PRACTICE POINTER:*** Unless required by an investor providing initial financing to the corporation, articles limitations on corporate powers should be avoided, because their removal requires shareholder approval (*see*¶ 8:52 ff.) and possibly a permit from the Department of Financial Protection and Innovation (*see* ¶ *8:83 ff.*). Even the above sample limitation (¶ *4:18*) barring the corporation from guaranteeing debts makes no sense if the corporation will organize one or more subsidiaries, since parent guarantees of subsidiary debt are common.

(c) [4:19] **Limited powers no defense to actions by third parties:** Inserting such limitations in the articles of incorporation is of little effect as far as third parties are concerned. The common law doctrine of "ultra vires" (which prohibited a corporation from exceeding its stated powers or purposes) has been largely repudiated in California. Thus, the corporation is bound in its dealings with third parties—even if they *knew* that such dealings were specifically prohibited to the corporation. [See Corps.C. § 208]

1) [4:20] **Examples:** A contract or conveyance made in the name of the corporation and authorized or ratified by its board is binding on the corporation regardless of any provision in its articles which purports to deny it the power to make such contract or conveyance. [Corps.C. § 208(b)]

2) [4:21] **Corporation may enforce:** Nor can such limitation be asserted as a defense by the third party to avoid its obligations under the contract. The corporation is entitled to *enforce* whatever rights it obtains under such contract or conveyance—even if the transaction was prohibited by its articles, and even if it is wholly executory. [See Corps.C. § 208(b)]

(d) [4:22] **Situations where limitations on corporate powers effective:** The only situations in which limitations on the corporation's powers and purposes will be given effect are:

- In proceedings by a shareholder or the State to *enjoin* the doing or continuation of unauthorized business by the corporation *where third parties have not yet acquired rights* against the corporation; or

- As ground for *dissolution* of the corporation; or

- As ground for suit by the corporation against the directors or officers for *damages* resulting to the corporation from their violating their authority; and if the corporation fails to sue, a *shareholder's derivative action* will lie. [Corps.C. § 208(a); *see* ¶ *6:279*]

For example, if the articles prohibit political campaign contributions, the corporate officers or directors causing the corporation to make such contributions could be held personally liable to the corporation. [See 60 Ops.Cal.Atty.Gen. 348 (1977)]

[4:22.1 - 4:22.4] ***Reserved.***

(e) [4:22.5] **Compare—SPCs:** An SPC's articles may contain an optional provision limiting or restricting the business in which the SPC may engage or the powers that the SPC may exercise "so long as consistent with the purpose of the social purpose corporation as set forth in the articles." [Corps.C. §§ 2604, 2605(a); *see* ¶ *9:5*]

d. [4:23] **Designation of initial agent for service of process:** The articles must state the name and street address in California of the corporation's initial agent for the service of process. [Corps.C. § 202(c); see also Corps.C. § 2602(c) (SPCs)]

This assures that the corporation will be subject to the jurisdiction of California courts in any action brought against it—even if the corporation has no office or personnel within the state.

Cross-refer: For considerations affecting choice of *who* should be designated as initial agent, *see*¶ *3:417*.

(1) [4:24] **Natural person or corporate agent:** The agent designated must be either a natural person residing in California, or a corporation having an office within the State. A corporate agent must file with the Secretary of State a certificate

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

designating its offices within California and its employees within this state who can be served. [See Corps.C. §§ 1502(b), 1505]

(2) [4:25] **Address of natural person:** If a natural person is designated as agent, their *complete business or residence street address* must be set forth in the articles. If a corporate agent is designated, no address for the corporation should be shown (the certificate on file will disclose where it can be served; *see ¶ 4:24*). [Corps.C. §§ 202(c), 1502(b)]

(3) [4:26] **Changing agent for service of process:** The corporation's agent for service of process can be changed on the annual statement that every corporation is required to file. [Corps.C. § 1502, *discussed at¶ 4:474*]

[4:27] If it is desired to change the agent for service of process *before* the corporation's first annual statement is due, the corporation would have to file a *restated* articles of incorporation. [See Corps.C. § 910(d)] (Amending the articles to change the designated agent is *not* permitted prior to filing the first annual statement under Corps.C. § 1502; see Corps.C. § 900(b).)

(a) Agent's resignation

1) [4:27.1] **Filing statement of resignation:** The agent designated in the articles may *resign* by filing a duly signed and acknowledged statement of resignation with the Secretary of State. This effectively terminates the agent's authority; and the Secretary of State must immediately advise the corporation of the resignation by written notice mailed to its principal office. [Corps.C. § 1503(a)]

• ***FORM:*** The Secretary of State's standard form Resignation of Agent Upon Whom Process May Be Served (RA-100) is available online at the Secretary of State's website (*www.sos.ca.gov*).

2) [4:27.2] **Disclaimer of appointment:** The agent may also resign by filing a disclaimer with the Secretary of State certifying that they were "*never properly appointed*"—i.e., they never agreed to serve prior to the appointment and subsequently never accepted appointment nor acted as if they had accepted appointment. (Persons named as officer or director may similarly disclaim appointment.) [Corps.C. § 1503(b); 2 CCR § 21906(a) (emphasis added)]

Filing of the disclaimer effects a *resignation* of the person as agent for service of process; the Secretary of State must immediately advise the corporation of the resignation by written notice mailed to its principal office. [2 CCR § 21906(b)]

• ***FORM:*** Disclaimer of Appointment, *see Form 4:A.4*.

(4) [4:27.3] **Compare—service of process on Secretary of State where no designated agent:** If there is no designated agent, or if the designated agent resigns and is not replaced, *any state or federal court* in which an action is filed may order —upon a showing that process cannot be served with reasonable diligence on the designated agent or corporation—that the corporation be served by *hand-delivery* of the process and order *to the Secretary of State'soffices*. Service is deemed complete on the 10th day after such delivery to the Secretary of State. [Corps.C. § 1702(a)]

[4:27.4 - 4:27.5] ***Reserved.***

e. [4:27.6] **Corporation's street/mailing address:** The articles must state the initial street address of the corporation's principal office. It also must state the corporation's initial mailing address if it is different from the initial street address. [Corps.C. § 202(d), (e)]

f. [4:28] **Authorized capital (share structure):** The articles must state the authorized share structure of the corporation.

(1) [4:29] **Single class of shares:** If the articles authorize only a single class of shares, the total number of shares which the corporation is authorized to issue must be stated. [Corps.C. § 202(f); see also Corps.C. § 2602(f) (SPCs, *¶ 9:31*)]

(a) [4:30] **Name of class:** There is no requirement that the single class have a name or be otherwise described in the articles. (E.g., "The corporation is authorized to issue 1,000 shares of stock.")

➪ [4:31] ***PRACTICE POINTER:*** Even so, it is a good idea to name them "common" shares. This facilitates identification of the original shares in the event an additional class of shares is later authorized by amendment to the articles.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) [4:32] **Number of shares authorized:** Nor is there any limit on the number of shares which the corporation may be authorized to issue. (While theoretically even a billion shares could be authorized, the number chosen usually is somewhere between a thousand and a million.)

1) [4:32.1] **Comment:** As a practical matter, the number of shares to be authorized depends on the number of shares planned to be issued initially. This in turn depends on how many shares (e.g., units of ownership) the organizers want to receive in exchange for their contributions. For example, in exchange for property having an agreed value of $10,000, the corporation could issue 1 share, 10 shares or 10,000 shares. There is total flexibility on the number of shares that can be issued. The important point is that, before drafting the articles and fixing an authorized number of shares, you need to know how many shares the clients want issued to themselves initially.

2) [4:32.2] **Caution—corporations doing business in other states:** In California, there is no extra cost for having a large number of authorized shares. The Secretary of State charges a fixed fee for filing the articles, regardless of the number of shares authorized.

However, some states (e.g., Delaware) base their filing or franchise fees on the corporation's authorized capital (i.e., total authorized shares multiplied by actual or deemed par value, ¶ *4:49.1*), and these fees apply equally to domestic and foreign corporations qualified to do business in those states (¶ *4:527*).

➪ [4:32.3] ***PRACTICE POINTER:*** It follows, therefore, that when establishing the authorized capital stock, counsel could check the laws of other states in which the corporation intends to do enough business to require qualification. Obviously, if fees are based on authorized capital, it may be desirable to authorize a very low par value (e.g., $0.01 per share) or downsize the share structure (e.g., authorize 1,000 and issue 100 shares, instead of authorizing 1,000,000 and issuing 100,000).

3) [4:33] **Planning for future share issuances:** It is generally a good idea to authorize *more shares than are planned to be issued initially* and thus establish an adequate “reservoir” of shares. The advantage, of course, is that this facilitates future share issuances by the corporation. There is no need to amend the articles to issue additional shares for expansion, financing, etc.

➪ [4:33.1] ***PRACTICE POINTER:****Discuss this with your clients before drafting the articles.* Some clients may prefer to *limit* the authorized shares to the number planned to be issued initially. This will prevent additional ownership interests from being created without shareholder approval (i.e., amending the articles). The concern usually is that future share issuances could dilute the voting power and financial interests of the organizers. (Even if the articles provide full preemptive rights (¶ *4:108*), this may not provide adequate protection because they may be financially unable to exercise such rights.)

(c) [4:34] **Compare—number of shares to be issued:** It is *not* proper to state in the articles how many shares are to be *issued*. The amount of shares to be issued, and the consideration for their issuance, are matters within the discretion of the board of directors (*see*¶ *5:10*).

However, the articles may (optionally) state the *minimum price* or consideration to be received for the shares; *see*¶ *4:104*.

(2) [4:35] **Several classes of shares:** If more than one class of shares is authorized (or if any class is to have several series), the articles must state, *or specifically authorize the board of directors to determine*:

• The designation of each class or series;

• The total number of shares authorized within each class;

• The total number of shares of each series or that the board is authorized to fix the number of shares of any such series; and

• The rights, preferences, privileges and restrictions of each such class or series. [Corps.C. § 202(g); see also Corps.C. § 2602(g) (SPCs, ¶ *9:32*)]

➪ [4:36] ***PRACTICE POINTER:*** Wherever possible, try to *avoid* complex capital structures in the articles of incorporation. They raise drafting problems, and often jeopardize the tax advantages and securities law exemptions otherwise available to the corporation (*see*¶ *3:167*). Also, once shares are issued, it is often difficult to amend the capital structure of the corporation provided in the original articles.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

As an alternative, it is often possible to provide the same result through *shareholders agreements*—i.e., the shareholders can *agree to vote their shares* so as to provide the rights, preferences or privileges that would otherwise have to be spelled out in the articles.

(a) [4:37] **Designation of each class or series:** Where the articles authorize more than a single class of shares, or more than one series of shares within the same class, the articles must designate a name for each such class and either designate, or authorize the board to designate, a name for each series. [Corps.C. § 202(g)(2); see also Corps.C. § 2602(g)(2) (SPCs)]

Typically, classes of shares will be designated as "Common," "Class A Common" and "Class B Common," or "Preferred"; and series of shares within the same class will be designated "Series A," etc.

1) [4:38] **Class vs. series:** A "series" means those shares within a class which differ in one or more rights, preferences, privileges or restrictions from others within the same class.

For example, the preferred shares as a whole may have dividend and liquidation priorities; but only certain of the preferred shares may be entitled to vote. In such a case, the voting preferred shares must be designated as a separate *series* of preferred ("Series A"); and the nonvoting shares as another ("Series B"). [See Corps.C. § 183]

However, certificated and uncertificated securities (*¶ 5:472*) do not constitute different series if this is the only difference between them. [Corps.C. § 183]

• ***FORM:*** Optional Articles Provision Authorizing Voting and Nonvoting Common Stock, *see Form 4:A.1a*.

(b) [4:39] **Number of shares in each class or series:** The articles must also state the number of shares of each *class* that the corporation is authorized to issue. [Corps.C. § 202(g)(1); see also Corps.C. § 2602(g)(1) (SPCs)]

Where there are several *series* of shares within the same class, the articles may either state the number of shares authorized in each series, *or,* alternatively, confer upon the board of directors the power to fix (by resolution) the number of authorized shares in each such series. (This applies only to shares in a *series*, and not to shares of a class.) [Corps.C. § 202(g)(1); see also Corps.C. § 2602(g)(1) (SPCs)]

1) [4:39.1] **Class of shares issuable in series:** The articles may authorize any class of shares to be issuable in one or more *series*. Where there are several series of shares within the same class, the articles may either:

• State the number of shares authorized in each series; or

• Confer upon the board of directors the power to fix by resolution the number of shares in each series. [Corps.C. § 202(g); see also Corps.C. § 2602(g) (SPCs)]

a) [4:39.2] **Designation of series where no common stock:** If the articles authorize a class of shares issuable in a series, but do not authorize a class of *common* shares, they must include the designation and number of shares for at least one such series within that class or an authorization of common shares. [Corps.C. § 203.5(c)]

b) [4:39.3] **Limitations on number of shares:** Further, where the articles state the designation and number of shares of one or more series within a class, the stated number of shares for *all* series within that class may not exceed (but may be less than) the total number of shares stated for that class. [Corps.C. § 203.5(a)]

c) [4:39.4] **Board action to increase or decrease shares of series:** The articles may also authorize the *board alone* (i.e., without shareholder approval) to increase or decrease the stated number of shares in a series, but not below the number of the series of shares then outstanding. [Corps.C. § 203.5(b)]

➪ [4:40] ***PRACTICE POINTER:*** The same practical considerations discussed earlier (*¶ 4:33*) apply in deciding whether to authorize more shares than are planned to be issued initially.

(c) [4:41] **Statement of rights, preferences, privileges and restrictions:** Finally, where more than a single class or series of shares is provided, the articles must either contain a statement of the rights, preferences, privileges and restrictions of each class or series, *or*, alternatively, *confer upon the board* of directors the power to do so as to any shares not yet issued. [Corps.C. § 202(g)(3); see also Corps.C. § 2602(g)(3) (SPCs)]

1) [4:42] **Particular rights, preferences, privileges and restrictions:** Voting rights; dividend rights (mandatory vs. discretionary, cumulative vs. noncumulative); participation rights; liquidation rights; voting rights on dividend default; conversion rights, etc. *See discussion at¶ 3:93 ff.*

a) [4:42.1] **Protections required by Financial Protection and Innovation Commissioner:** Where the articles create preferred stock that is both *nonparticipating* and *nonconvertible*, to qualify such shares for issuance under

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

the Corporate Securities Law, the articles will also have to contain certain minimum protections for the preferred shareholders—cumulative dividends, voting rights on dividend default, etc. [See Commr. Rules 260.140.2 & 260.140.3, ¶ 3:125 ff.]

• ***FORM:*** Optional Articles Provisions Authorizing Common and Preferred Stock with Attributes Specified, *see Forms 4:A.1b ff.*

2) [4:43] **Board may be authorized to determine:** As stated, the board may be authorized to determine any such rights, preferences or privileges … including such matters as dividends, voting rights, priority upon liquidation, redemption rights, conversion rights, etc. [Corps.C. § 202(g)(3); see also Corps.C. § 2602(g)(3) (SPCs)]

• ***FORM:*** Optional Articles Provision Authorizing Common and Preferred Stock "In Blank" (Board to Fix Attributes), *see Form 4:A.1i*.

➪ [4:44] ***PRACTICE POINTER:*** It is often a good idea to confer on the board the power to make such determinations. It makes it easier to modify such rights, preferences, etc., if circumstances so require, without the formalities required to amend the articles of incorporation.

Keep in mind, however, that any action by the board is effective only as to a class or series of shares that has *not yet been issued*. Any later amendment or revision of the directors' resolution has no effect on the rights of shares already issued.

a) [4:45] **Certificate of determination to be filed with Secretary of State:** If the articles confer such authority upon the board, the corporation must file with the Secretary of State a "certificate of determination" by the board *before the affected shares are issued*. The certificate must contain a copy of the board's resolution establishing the rights of each class or series. [See Corps.C. §§ 156, 401]

Upon filing, the certificate *becomes a part of the articles of incorporation*. [Corps.C. § 154]

• ***FORM:*** Certificate of Determination, *see Form 4:A.2*.

3) [4:45.1] **Attributes may be made dependent on facts outside articles:** The attributes of the shares may be made dependent upon facts ascertainable *outside* the articles, so long as the *manner* in which those facts operate upon such provisions is *clearly* and *expressly* set forth in the articles. [Corps.C. § 109.5(a); see also Corps.C. § 2502.06(a) (SPCs); *and*¶ *4:60.1 ff.*]

For example, in private placements of preferred stock, the articles may provide for "optional rights" (e.g., optional redemption rights, increased voting rights, etc.) of the preferred shareholders in *event of breach* or default by the corporation of agreements made with such holders. In such cases, the articles provisions relating to the preferred shares can authorize the "optional rights" by reference to the preferred stock purchase agreement and make them dependent upon specified breaches of the agreement.

(d) [4:46] **No distinction exists unless stated or authorized in articles:** Any priority or preference between classes or series of shares must be stated in the articles of incorporation or a certificate of determination filed by the corporation. Otherwise, *no distinction shall exist* between the classes or series of shares or the holders thereof. [Corps.C. § 203]

(3) [4:47] **"Par value" designation inappropriate:** Ordinarily, it is inappropriate for the articles either to designate a "par value" for the shares, or to state that the shares have "no par value." Reason: California law no longer recognizes any distinction between par and no-par value stock. [See Corps.C. §§ 202, 204, 205]

(a) [4:48] **Compare—for tax and fee purposes:** However, for purposes of fixing *taxes or fees* based upon the capitalization of the corporation, all shares authorized are deemed to have a "nominal or par value" of $1 per share. [Corps.C. § 205]

(b) [4:49] **Compare—for securities law purposes:** Moreover, if in order to qualify under federal securities laws or regulations, shares are required to have a stated or par value, the board of directors is authorized to determine a "par" value for such shares. (But such attribution of par value is *not* included in the articles; it would be established by resolution of the board of directors, or possibly adopted as a bylaw.) [Corps.C. § 205]

(c) [4:49.1] **Compare—corporations qualified in other states:** If the corporation fails to specify a par value and subsequently qualifies to do business in another state (¶ *4:527*), applicable state law may assign some arbitrary par value (e.g., $1 or $10) to be used when necessary to calculate certain filing or franchise fees that are based upon the

corporation's "authorized capital" (total authorized shares multiplied by par value). To minimize those fees, counsel may wish to limit the number of authorized shares or assign a par value of $0.01 or less per share (*see*¶ *4:32.2 ff.*).

2. [4:50] **Optional Provisions for Inclusion in Articles:** In addition to the required provisions described above (¶ *4:3 ff.*), the articles of incorporation *may* include various other, optional provisions. As stated in the Code, the articles may set forth "[*a*]*ny other provision*, not in conflict with law, for the management of the business and for the conduct of the affairs of the corporation, including any provision which is required or permitted… to be stated in the *bylaws*." [Corps.C. § 204(d) (emphasis added); see also Corps.C. § 2603(d) (SPCs)]

a. [4:51] **Purpose:** The most common purpose for including such additional, optional provisions is to *alter some statutory standard* otherwise applicable to the corporation. This allows the organizers to set up a financial/control structure better suited to their particular needs than the general standards of the Corporations Code. For example, the organizers may want to limit the powers of the directors in certain respects; or to confer on the shareholders greater rights than provided by the General Corporation Law.

(1) [4:52] **Limitation—prohibited provisions:** Some statutory standards *cannot* be varied, and contrary provisions in the articles are prohibited and void (*see*¶ *4:91, 4:137*).

b. [4:53] **Counsel's responsibility re optional provisions:** The organizers should be advised of the options available to them, so that they are not strapped into an undesired financial/control structure.

(1) [4:54] **Comment:** Too often, corporations are formed with "short form" articles and boilerplate bylaws, with no real consideration given to including the optional provisions discussed below (¶ *4:61 ff.*). As a result, the principals may find that the articles or bylaws need to be amended to carry out their particular purposes. But amendments can be time-consuming and expensive, and may be opposed by dissident groups of directors or shareholders. These problems can be avoided by proper planning and drafting when organizing the corporation.

c. [4:55] **Whether to include in articles or bylaws:** Many (but not all) of the provisions discussed below are effective *only* if included in the corporation's articles. Others, however, may be included *either* in the articles *or* in the *bylaws* (or in some cases, even in a separate shareholders agreement or resolution by the board of directors).

(1) [4:56] **Approach:** Consequently, in advising the organizers as to these optional provisions, counsel needs to make several determinations:

- First of all, is the proposed provision *lawful* (i.e., can the statutory standard be varied)?

- If lawful, *must* it be included in the *articles* in order to be effective … or is it one of those provisions that simply *may* be included in the articles, but is equally effective if set forth solely in the bylaws?

- And finally, even if the provision does not have to be included in the articles in order to be effective, *should* it be included in the articles … or should it be set forth elsewhere—e.g., in the bylaws, or in a shareholders agreement, or simply by resolution of the board of directors?

➪ [4:57] ***PRACTICE POINTER:*** Where a choice is possible, many experienced lawyers choose *not* to include additional, optional provisions in the articles of incorporation—i.e., unless the provision *has* to be included in the articles in order to be effective (*see* ¶ *4:55*), you may want to include it instead in the corporation's *bylaws* or in *shareholders agreements.*

(2) [4:58] **Reasons for *not including in articles:*** Matters contained in the articles are matters of *public record*, and sometimes the parties wish to avoid disclosing the details of the corporation's financial and control structure. Also, matters contained in the articles can only be changed by formal *amendment* of the articles, which may be costly and time-consuming (requiring approval by both the directors *and* shareholders if shares have been issued). Finally, the more complex the provision, the more careful the lawyer has to be in drafting it (to make sure that it conforms to the Code requirements for articles of incorporation and accomplishes the client's objectives).

In contrast, bylaw provisions are *not* matters of public record; and they can be changed by the board of directors, usually without shareholder approval. Likewise, shareholders agreements can be kept private, and can be changed more easily (although normally all parties to the agreement have to approve the changes).

(3) [4:59] **Possible reasons for including in articles:** On the other hand, there may be situations in which the organizers *want* certain provisions included in the articles that need not be so included in order to be effective. For example, the

organizers may want certain provisions to appear as a matter of public record (e.g., limitations on business activities). Or, they may want certain "housekeeping" provisions made a more permanent part of the corporate structure, and more difficult for future boards and shareholders to change.

➪ [4:60] ***PRACTICE POINTER:*** If you decide to include additional, optional provisions in the articles, and have some question whether the provisions you prepared will be accepted for filing by the Secretary of State, you can submit them for review before filing. The charge for this service is $250 to $500, depending on how quickly a response is desired (one-to-10 business days). Also, the document must be *hand-delivered* to the Secretary of State's office in Sacramento (1500 11th Street), so attorneys outside the Sacramento area may incur the additional cost of employing a filing or similar service. [See 2 CCR §§ 21903-21905.5]

The prereview time and expense may be worthwhile to avoid embarrassment and delay in the event the articles are rejected by the Secretary of State because of perceived drafting defects or failure to conform to law (*see*¶ *4:167*).

d. [4:60.1] **Reference to outside facts or documents:** Articles provisions may be made dependent upon facts ascertainable *outside* the articles themselves, provided that the *manner* in which such extraneous facts operate on those provisions is *clearly* and *expressly* set forth in the articles. [Corps.C. § 109.5(a); see also Corps.C. § 2502.06(a) (SPCs)]

Thus, specified articles provisions may be made dependent upon an extrinsic agreement or document referred to in the articles. (*See*¶ *4:45.1*.)

(1) [4:60.2] **Application:** This procedure may be applied, for example, to articles provisions that:

(a) [4:60.3] Establish the rights, preferences, privileges and restrictions of each class or series of shares (¶ *4:45.1*);

(b) [4:60.4] Grant power to levy assessments on shares (¶ *4:106*);

(c) [4:60.5] Establish qualifications of persons who may be shareholders (¶ *4:98*);

(d) [4:60.6] Impose super-majority shareholder voting requirements, or super-majority voting or quorum requirements for directors (¶ *4:83 ff., 4:114*);

(e) [4:60.7] Require that the shareholders, or outstanding shares, approve specified corporate actions (¶ *4:122*);

(f) [4:60.8] Impose reasonable restrictions on transferability of shares (¶ *4:131*);

(g) [4:60.9] Grant preemptive rights to shareholders (¶ *4:108*);

(h) [4:60.10] Limit the duration of the corporation's existence (¶ *4:62*);

(i) [4:60.11] Restrict or limit the corporation's business or powers (¶ *4:64*);

(j) [4:60.12] Grant debt holders voting rights (¶ *4:144*);

(k) [4:60.13] Grant shareholders the right to determine the consideration for which shares shall be issued (¶ *4:102*). [Corps.C. § 109.5(a); see also Corps.C. § 2502.06(a) (SPCs)]

(2) Special requirements as to referenced agreements

(a) [4:60.14] **Shareholder approval of amendments:** Where articles provisions are dependent on an extrinsic agreement to which the corporation is a *party*, shareholder approval may be required for amendments to the agreement. Any *amendment* or revision of such agreement must be approved by the outstanding shares (¶ *6:9*) of *each affected* class or series, if it would:

- Result in any *material change* in the rights, preferences, privileges or restrictions of any class or series of shares; *or*

- Result in any material change in the rights or liabilities of any class or series of shares as to any of the matters described above in ¶ *4:60.3 ff.* [Corps.C. § 109.5(c)(1)-(3); see also Corps.C. § 2502.06(c)(1)-(3) (SPCs)]

(*Compare:* The statute does not require shareholder approval where the corporation is *not a party* to the agreements or documents referenced in the articles—e.g., a close corporation shareholders agreement.)

➪ [4:60.14a] ***PRACTICE POINTER:*** It is unclear when an amendment to a referenced extrinsic agreement (to which the corporation is a party) constitutes a "material change" in the agreement (¶ *4:60.14*). Thus, the safest course is always to obtain approval of any amendment by the outstanding shares of each affected class.

(b) [4:60.15] **Copies must be maintained:** The corporation must maintain a copy of such referenced agreements or documents (and all amendments thereto) at its principal office. If the shareholders request in writing, they must

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

be provided with copies of such agreements or documents free of charge. [Corps.C. § 109.5(b); see also Corps.C. § 2502.06(b) (SPCs)]

➪ [4:60.16] ***PRACTICE POINTER:*** This procedure eliminates the need to set forth lengthy provisions in the articles. Perhaps more importantly, such provisions in extrinsic agreements are *not matters of public record*, as are articles (*see*¶ *4:58*).

e. [4:61] **Particular optional provisions:** The following are the optional provisions most frequently considered for inclusion in the corporation's articles. As will be seen, some of these provisions are effective *only* if included in the articles; others are equally effective if included in the bylaws (or even elsewhere such as in shareholders agreements).

(1) [4:62] **Optional provision limiting corporate existence:** Corporations have perpetual existence unless the articles provide otherwise (*see*¶ *2:43*). Consequently, if the organizers want their corporation to terminate and wind up its affairs after a certain period of time, or on the happening of a certain event (e.g., the sale of the property which it was formed to hold), such a provision must be included in its articles of incorporation in order to be effective. [Corps.C. § 204(a)(4); see also Corps.C. § 2603(a)(4) (SPCs)]

(a) [4:63] **Comment:** Such a provision is rare because the shareholders can always elect to wind up and dissolve the corporation voluntarily. But it might make sense where they want the corporation liquidated at a specified future time and are concerned that they might lack the necessary votes to dissolve, or want to avoid the possibility of a contested dissolution (*see* ¶ *8:791*).

(2) [4:64] **Optional provision limiting powers of corporation:** As discussed earlier, if it is desired to limit the corporation's powers or purposes in some way (e.g., to prevent it from engaging in certain businesses, etc.), such limitation *must* appear in the articles of incorporation in order to be effective. Otherwise, the corporation will have power to engage in "any lawful act or activity." [Corps.C. § 204(a)(6); see also Corps.C. § 2603(a)(6) (SPCs); *and* ¶ *4:14*]

Provisions limiting corporate powers are generally set forth as part of, or immediately following, the paragraph containing the required statement of purposes; *see*¶ *4:17*.

(3) [4:65] **Optional provisions relating to directors:** Various provisions relating to directors and the functioning of the board may (optionally) be included in the articles of incorporation, including:

- Designating the initial directors;
- Fixing the authorized number of directors;
- Providing for the election of directors by class or series of shares;
- Establishing directors' qualifications;
- Providing that directors hold office for less than one-year terms to effect a voting shift (i.e., a change in the voting rights of share classes to elect directors; *see*¶ *3:114 ff.*);
- Requiring super-majority vote or quorum, or less-than-majority quorum for director action;
- Restricting the authority of directors in certain respects;
- Limiting directors' liability;
- Authorizing indemnification of directors (and other corporate agents) beyond that permitted by Corps.C. § 317;
- Dividing the boards of "listed" corporations into 2 or 3 classes to serve for terms of 2 or 3 years respectively—i.e., "staggered" terms (*see*¶ *4:77a ff.*);
- Eliminating cumulative voting for directors of "listed" corporations (*see*¶ *4:88.13 ff.*);
- (Where cumulative voting has been eliminated) requiring that a director of a "listed" corporation be elected by a majority of shares voting at an uncontested election of directors (*see*¶ *4:88.20 ff.*, *6:8, 6:11*).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[4:66] **Note:** Most of the foregoing could be included in the corporation's *bylaws* with the same legal effect. However, provisions eliminating or limiting directors' liability, authorizing expanded indemnification of corporate agents, or permitting election of directors *by class* or series of shares must be included in the articles to be effective (*see*¶ *4:88.1 ff., 3:155*).

(a) [4:67] **Designation of initial directors:** It is optional to include in the articles the names and addresses of the initial directors of the corporation. [Corps.C. § 204(c); see also Corps.C. § 2603(c) (SPCs)]

(Where the initial directors are so designated, it is customary for the articles also to state the *number* of directors authorized. But it is not required.)

1) [4:68] **Must execute articles:** If the initial directors are named in the articles, they must sign and *acknowledge* the articles as the incorporators and initial directors. [Corps.C. § 200(b); see also Corps.C. § 2600(b) (SPCs); *and*¶ *4:146 ff.*]

➪ [4:69] ***PRACTICE POINTER:*** For this reason, it may be disadvantageous to include the names of the initial directors. And, sometimes it is better for business purposes that the organizers' names *not* appear as a matter of public record (i.e., using incorporators instead).

Some attorneys, however, recommend including the names and addresses of the initial directors in the articles: It gives the organizers an immediate sense of identification with the new corporation—as opposed to having some third party (often the lawyer) appear as the incorporator. Also, should a dispute arise among the organizers, it avoids having the incorporator caught in the middle with conflicting instructions as to whom to appoint as the initial board (*see* ¶ *3:422*).

(b) [4:70] **Establishing number (or range) of directors:** It is optional to include in the articles the number or range of directors (i.e., "not less than … nor more than …"). [Corps.C. § 212(a)]

(If not included in the articles, a bylaw has to be adopted prior to the first meeting of the board, establishing the size of the board; *see*¶ *4:276.*)

➪ [4:71] ***PRACTICE POINTER:*** Including the authorized number or range of directors in the articles avoids the problem created where bylaws stating the number of directors are not properly adopted prior to the organizational meeting of the board (*see* ¶ *4:399*).

However, there is a drawback: To change the number of directors will require an amendment to the articles, which is more cumbersome and expensive than amending the bylaws and requires shareholder approval. (But note that shareholder approval would also be required to change a *bylaw* provision governing the range or number of directors; *see* ¶ *4:182*.)

The need for shareholder approval to change the authorized number of directors may be reduced, however, by a provision for a "flexible board" (*see* ¶ *4:74*).

1) [4:72] **Required minimum:** Except for "*listed*" corporations with staggered terms (*see* ¶ *4:77a ff.*) or as stated below, a corporation is required by law to have *at least three* directors. [Corps.C. § 212(a)]

The exceptions are these: Before any shares are issued, fewer than three directors are allowed. And even after shares are issued, the minimum number of directors may be one so long as the corporation has only one shareholder; and so long as the corporation has only two shareholders, the minimum number may be two. [Corps.C. § 212(a)]

2) [4:73] **Authorizing fixed number:** A fixed number of directors may be specified in the articles or bylaws, so long as that number satisfies the minimum requirements above (¶ *4:72*). [Corps.C. § 212(a)]

• ***FORM:*** Optional Articles Provision Establishing Fixed Number of Directors, *see Form 4:A.1k*.

a) [4:73.1] **Odd vs. even number of directors:** If the articles or bylaws fix an even number of directors, there is always a potential for corporate deadlock; and, this risk is intensified if the voting shares are split evenly between different factions of shareholders. For this reason, most attorneys recommend an odd number of directors—the effect of which is to leave it up to the *shareholders* to decide which directors will control the corporation.

➪ [4:73.2] ***PRACTICE POINTER:*** If the organizers insist upon an even number of directors, urge them (as strongly as possible) to enter into a buy-sell agreement with provisions for a *mandatory* buy-out in the event there is a deadlock on the board.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b) [4:73.3] **Comment:** Otherwise, the only deadlock-breaking devices are a petition for a court order appointing a *provisional director* (Corps.C. § 308; *see*¶ *8:845*); or proceedings for *voluntary or involuntary dissolution* (*see*¶ *8:752, 8:794*).

3) [4:74] **Authorizing variable numbers of directors ("flexible board"):** In lieu of a fixed number, the articles may authorize a "flexible board": i.e., a minimum and a maximum number authorized, with the exact number within such range *to be determined by either by the board of directors or the shareholders*. The only limitation is that the maximum cannot be more than twice the minimum, minus one. [Corps.C. § 212(a)]

a) [4:75] **Example:** The articles may authorize a number of directors "not less than five nor more than nine" (twice the stated minimum of five, less one), with the exact number to be fixed and determined either by the board of directors or shareholders.

In such event, the size of the board could expand or contract within the limits specified (i.e., between five and nine) by appropriate resolution of the directors or action of the shareholders, once the shares are issued.

• ***FORM:*** Optional Articles Provision Establishing Variable Number of Directors, *see Form 4:A.1I*.

b) [4:76] **Caution—risk to minority shareholders:** A "flexible board" makes particular sense where the corporation has strong growth potential, and the need for a larger number of directors can be foreseen. On the other hand, it may not be desirable for minority shareholders, because reducing the number of directors means *more shares will be required to assure representation* on the board under cumulative voting (*¶ 3:145*).

4) [4:77] **Compare—limit on amendments reducing size of board:** To protect cumulative voting rights, the Code limits reductions in the size of the board: Once shares have been issued, the articles or bylaws cannot be amended to reduce the number of directors (or the minimum number on a "flexible board") *below five*, if the votes cast against such amendment represent more than 1/6th of the outstanding shares entitled to vote at a shareholders' meeting for election of directors (i.e., holders of 16.67% of the voting shares are protected against losing their power to elect one director on a five-person board). [Corps.C. §§ 194.5, 212(a)]

5) [4:77a] **Special rules for "listed" corporations with staggered terms:** Corporations with shares listed on the New York Stock Exchange, NYSE American (formerly NYSE Amex), Nasdaq Global Market or Nasdaq Capital Market may, by *amendment* to their articles (or bylaws), divide their boards into two or three classes to serve for terms of two or three years, respectively (i.e., staggered terms). [Corps.C. § 301.5; *see*¶ *8:91*]

(By amending their articles or bylaws, "listed" corporations may also eliminate cumulative voting for directors; *see*¶ *4:88.13 ff.*)

a) [4:77b] **Six-director minimum where two-year staggered terms:** If the board of directors is divided into two classes elected for staggered two-year terms, the authorized number of directors must be *at least six*, with one-half (i.e., *at least three*) being elected at each annual shareholders' meeting. [Corps.C. § 301.5(b)]

b) [4:77c] **Nine-director minimum where three-year staggered terms:** If the board is divided into three classes elected for staggered three-year terms, the authorized number of directors must be *at least nine*, with one-third (i.e., *at least three*) being elected at each annual shareholders' meeting. [Corps.C. § 301.5(b)]

c) [4:77d] **Compare—*"unlisted" corporations may adopt staggered term provisions to take effect upon listing:*** Once a corporation has issued shares, it may *amend* its articles (or bylaws) to establish staggered terms for its directors *to be effective when the corporation becomes "listed."* [Corps.C. § 301.5(a), (g), (j)] The amendment should include the following statement:

> "This provision shall become effective only when the corporation becomes a listed corporation within the meaning of Section 301.5 of the Corporations Code."

d) [4:77e] **Effect of "delisting" on staggered terms:** When a listed corporation having a staggered board *ceases to be "listed"* for any reason, the board ceases to be divided into classes as to each class of directors upon the expiration of their respective terms (unless the corporation's articles or bylaws provide for an earlier elimination of such classes). The term of each director serving on the board at the time the corporation ceases to be "listed" (and

of any successor director elected to fill a vacancy upon the death, resignation or removal of any such director) continues until its normal expiration. [Corps.C. § 301.5(e)]

[4:77f - 4:77i] ***Reserved.***

e) [4:77j] **Compare—"listed" golf and tennis corporations:** The articles or bylaws of a "listed" corporation whose business is limited to the operation and maintenance of a recreational venture having *golf and tennis facilities* (and ancillary dining and beverage services), and whose articles or bylaws limit each holder of the corporation's securities to *no more than five shares* and require "*some*" of those holders to occupy dwellings immediately contiguous to the corporation's real property, may divide its board into two classes for any specified terms(s) and without any required minimum number of directors so long as one-half of the directors (or as close an approximation as possible) is elected annually. [Corps.C. §§ 301.5, 301.7(a) (emphasis added)]

1/ [4:77k] **Board and shareholder approval requirement:** An articles or bylaws amendment providing for a staggered board must be approved by the board *and* by the outstanding shares voting as a single class. [Corps.C. §§ 301.5(a), 301.7(a)]

(c) [4:77.1] **Limiting directors' term to effect voting shift:** If the articles provide for a voting shift among share classes (e.g., upon specified arrearages in preferred share dividend payments; *see* ¶ *3:114 ff.*), they may also provide that directors hold office for less than one year to effect the voting shift. (Such a provision may not be included in the bylaws.) [Corps.C. § 301(a)]

(d) [4:78] **Establishing qualifications for directors:** The articles or bylaws may (optionally) establish qualifications, duties and even compensation for the directors. [Corps.C. § 212(b)(4)]

1) [4:79] **Example:** A common provision is a requirement that the members of the board be shareholders of the corporation: "Each director, to be qualified to take and hold such office, shall at all times during the term of such office, be the beneficial owner of at least … [number] of the corporation's common shares."

2) [4:79.1] **Independence requirements for directors of "listed" corporations:** *See* ¶ *4:278.1*.

3) [4:79.2] **Female director requirements for "listed" corporations:** *See* ¶ *4:278.2 ff.*

4) [4:79.3] **Requirements for directors from underrepresented communities for "listed" corporations:** *See* ¶ 4:278.3 ff.

(e) [4:80] **Provisions for less-than-majority quorum:** Normally, a majority of the authorized number of directors must be present to constitute a quorum for a board meeting (Corps.C. § 307(a)(7); *see* ¶ *6:211*). But, if the articles or bylaws so provide, the number required to constitute a quorum may be reduced to as little as *one-third* the authorized number of directors, or *two* directors, whichever is larger. [Corps.C. § 307(a)(7); *see* ¶ *6:212*]

1) [4:81] **Caution:** The smaller the quorum allowed, the greater the possibility that a slim minority of the directors can bind the corporation.

For example, if the authorized number of directors is seven, at least four directors would normally have to be present to constitute a quorum; and it would take the votes of a majority of those present (i.e., at least three of the four) to constitute board action. But if the quorum is reduced from four to three, then even as few as *two* directors could take effective action, binding the corporation.

2) [4:82] **Compare—provisions for less than majority vote prohibited:** Neither the articles nor bylaws may permit action to be taken by a *less than majority vote* of the directors *present* at a meeting at which a quorum is present. [Corps.C. § 307(a)(8); *see* ¶ *6:221*]

E.g., in the example above (¶ 4:81), if all seven of the authorized directors were present (or even six of them), action would require the vote of four of them; and no article or bylaw provision could reduce this number.

(f) [4:83] **Provisions for supermajority vote or quorum of directors:** The articles may require that more than a majority of the authorized directors (up to and including 100% of the directors) be present to constitute a quorum at board meetings. [Corps.C. § 204(a)(5); see also Corps.C. § 2603(a)(5); *and* ¶ *6:212*]

Further, the articles may require the vote of more than a majority of the directors present at the meeting (again, up to and including 100%) to take action at such meeting. [Corps.C. § 204(a)(5); see also Corps.C. § 2603(a)(5) (SPCs); *and* ¶ *6:221*]

• ***FORM:*** Optional Articles Provision Requiring Super-Majority Vote of Directors, *see Form 4:A.1m*.

1) [4:84] **Comment:** A supermajority vote or quorum requirement should not be included in the articles unless the organizers clearly intend to "freeze" the financial/control structure of the corporation. If included, it may be difficult to get rid of; i.e., unless the articles permit a lesser vote, the provision itself cannot be amended or repealed except by such greater vote of the directors (plus whatever shareholder approval may be required). [Corps.C. § 902(e)]

[4:85] ***Reserved.***

(g) Filling vacancies on board

1) [4:86] **Vacancy resulting from director's resignation or death:** By statute, vacancies on the board arising from the resignation or death of one or more directors may be filled upon approval of the *remaining* directors—even if less than a quorum remain (*see¶ 6:215.2*); and even if there is only one remaining director. [Corps.C. § 305(a)]

However, the articles or bylaws may provide otherwise: For example, the articles may provide that the power to fill such vacancies may be vested exclusively in the shareholders rather than the remaining directors. [Corps.C. § 305(a)]

2) [4:87] **Vacancy resulting from removal of director:** By statute, only the shareholders (and *not* the remaining directors) can fill vacancies on the board resulting from the *removal* of one or more directors. [Corps.C. § 305(a); *see¶ 6:18.1*]

But again, the articles or a bylaw *approved by the shareholders* may provide otherwise: i.e., the power to appoint a director to replace a *removed* director *can* be granted to the remaining members of the board. [Corps.C. § 305(a)]

(h) [4:88] **Restricting power of directors to adopt, amend, or repeal bylaw provisions:** The articles (as well as the bylaws) may restrict or eliminate the power of the board to adopt, amend, or repeal any or all bylaws. [Corps.C. § 211]

(i) [4:88.1] **Provisions limiting directors' liability:** Subject to important limitations, the articles may relieve the directors from personal liability to the corporation for breaches of their duty of care (e.g., from liability for negligence or gross negligence). [Corps.C. § 204(a)(10), *¶ 6:244 ff.*; see also Corps.C. § 2603(a)(10) (SPCs, *¶ 9:43*)]

Compare: The Delaware General Corporation Code permits exculpation of certain officers as well as directors for some claims. [See 8 Del.C. § 102(b)(7)]

FORM: Optional Articles Provision Limiting Directors' Liability, *see Form 4:A.1n*. (This form is contained in Corps.C. § 204.5(a) and provides the *maximum* limitation of directors' liability permitted by law.)

➪ [4:88.1a] ***PRACTICE POINTER:*** The language suggested by Corps.C. § 204.5(a) is not mandatory. However, the Secretary of State has taken the position that if such language is materially altered, the articles amendment must recite all the statutory limitations (¶ 4:88.3 ff.) or incorporate them by reference to Corps.C. § 204(a)(10) (or Corps.C. § 2603(a)(10) in the case of SPCs).

➪ [4:88.2] ***PRACTICE POINTER:*** Such a provision should *always* be included in the articles (unless, for some reason, the principals object). There are no disadvantages, and it will shield the directors from exposure to derivative suits based on allegations of negligence or gross negligence (but not egregious misconduct, *¶ 4:88.6*). This may be highly desirable where directors' and officers' liability insurance is prohibitively expensive or unavailable, and where there are many corporate shareholders having no personal relationship with the directors.

1) Limitations

a) [4:88.3] **Not retroactive:** Such an articles provision cannot eliminate or limit the liability of a director for misconduct occurring *before* the provision was adopted and became effective. [Corps.C. § 204(a)(10)(B); see also Corps.C. § 2603(a)(10)(B) (SPCs)]

b) [4:88.4] **No insulation from direct shareholder actions:** Directors may only be relieved of liability *to the corporation*—i.e., from direct suits against them by the corporation or *derivative* suits brought by shareholders on the corporation's behalf (*see¶ 6:598 ff.*). Directors remain personally liable in connection with *direct* shareholder suits, whether brought individually or as a class action (but it is unclear to what extent such actions may be brought; *see¶ 6:250.4*). [Corps.C. § 204(a)(10); see also Corps.C. § 2603(a)(10) (SPCs)]

c) [4:88.5] **Insulated only from monetary damages:** Moreover, directors may be relieved from liability to the corporation only for *monetary* damages. They remain subject to other types of appropriate relief (e.g., injunctions or other equitable orders). [Corps.C. § 204(a)(10); see also Corps.C. § 2603(a)(10) (SPCs)]

d) [4:88.6] **No insulation re highly culpable misconduct:** Further, the articles may not relieve directors from liability for certain specified acts of *egregious* misconduct (the "seven deadly sins"). [See Corps.C. § 204(a)(10)(A), *discussed at¶ 6:250.6;* see also Corps.C. § 2603(a)(10)(A) (SPCs, *¶ 9:43*)]

e) [4:88.6a] **No relief from liability under federal law:** Nor are directors relieved from liability for violations of *federal* law.

f) [4:88.7] **Inapplicable to officers:** Finally, corporate *officers* may not be similarly relieved of liability for breaches of their duties to the corporation. This limitation applies to director-officers acting in their capacity as officers, even if their misconduct has been ratified by the directors. [Corps.C. § 204(a)(10)(C); see also Corps.C. § 2603(a)(10)(C) (SPCs)]

(j) [4:88.8] **Provisions authorizing expanded director indemnification:** The articles may also authorize the corporation—through the bylaws, agreement or otherwise—to indemnify its directors (*and* officers and other agents) from liability for breach of duty to the corporation and its shareholders to a greater extent than permitted by the statutory indemnification provisions (Corps.C. § 317; *¶ 6:470.3*). Of course, the articles may similarly authorize greater indemnification of the directors and officers from liability for acts or omissions *not involving any breach of duty*. [Corps.C. § 317(g)]

• ***FORM:*** Optional Articles Provision Authorizing Expanded Indemnification of Corporate Directors, Officers and Agents, *see Form 4:A.1**o***. (This form was suggested by the Secretary of State, and authorizes the *maximum* indemnification that may be permitted by law.) (*Caution:* The form probably is not suitable for an SPC; *see ¶ 4:88.10*.)

1) Limitations

a) [4:88.9] **Egregious misconduct:** However, the articles may not permit directors (or other agents) to be indemnified for *all* misconduct. Indemnification may be authorized only for those breaches for which a director may also be relieved of damages liability (*¶ 4:88.8*). [Corps.C. § 204(a)(11)]

Thus, directors may not be indemnified for certain types of *egregious misconduct* (see Corps.C. § 204(a)(10)(A), *discussed at¶ 6:250.6*).

b) [4:88.9a] **Indemnification prohibited by statute:** Nor may the articles authorize indemnification under circumstances where indemnity is expressly prohibited by Corps.C. § 317 (*see¶ 6:464.2*). [Corps.C. § 204(a)(11)]

2) [4:88.10] **Compare—SPCs:** The articles of an SPC may also provide for indemnification of directors (and other persons), but the statutory indemnification provisions governing SPCs vary from those governing other corporations. *See¶ 9:43 ff.*, *9:121 ff.*

3) [4:88.11] **Comment:** An articles provision authorizing expanded indemnification of corporate agents primarily will benefit a *publicly-held corporation*. Reason: It is the directors, officers and other agents of publicly-held corporations who typically run a risk of shareholder derivative and class actions, and who may need and seek additional indemnification. (In contrast, derivative suits are much less likely in small, closely-held corporations in which management and the shareholders have a personal relationship.)

➪ [4:88.12] ***PRACTICE POINTER:*** Even so, unless the principals object, such a provision should *always* be included in every corporation's articles (whether public or closely-held). There are no disadvantages in doing so.

(k) [4:88.13] **Eliminating cumulative voting for directors—"listed" corporations only:** As discussed at *¶ 3:148 ff.*, corporations with shares listed on New York Stock Exchange, NYSE American (formerly NYSE Amex), Nasdaq Global Market or Nasdaq Capital Market may, by *amending* their articles (or bylaws), eliminate cumulative voting for directors. [Corps.C. § 301.5; *see¶ 8:91*]

("Listed" corporations may also establish staggered terms for directors; *see¶ 4:77a ff.*)

1) [4:88.14] **Limitation on removal of directors:** However, even if cumulative voting for directors is eliminated, an individual director cannot be *removed* during their term of office if the votes against removal would have been

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

enough to elect that director through *cumulative voting* where the corporation has also established a "classified" board. [Corps.C. § 303(a)(3); *see*¶ *4:77a ff., 6:236*]

2) [4:88.15] **Compare—"*unlisted" corporations may adopt such provision effective upon listing:*** After a corporation has issued shares, it may *amend* its articles (or bylaws) to eliminate cumulative voting *to be effective when the corporation becomes "listed."* [Corps.C. § 301.5(a), (g), (j)] The amendment should include the following statement:

> "This provision shall become effective only when the corporation becomes a listed corporation within the meaning of Section 301.5 of the Corporations Code."

a) [4:88.16] **"Delisting" restores cumulative voting:** If a corporation that eliminated cumulative voting ceases to be "listed" for any reason, its shareholders are entitled to vote cumulatively at any election of directors occurring while the corporation is "delisted." [Corps.C. § 301.5(f)]

Where a corporation ceases to be "listed" on or after the record date for a shareholders' meeting (¶ *4:235 ff.*) and prior to the conclusion of the meeting (including any adjournment or postponement not requiring a new record date), the corporation is not deemed to be "delisted" until after the shareholders' meeting has concluded. [Corps.C. § 301.5(h)]

[4:88.17 - 4:88.19] ***Reserved.***

(*l*). [4:88.20] **Requiring director's election by majority vote in uncontested election—"listed" corporations without cumulative voting:** A corporation that has shares listed on the New York Stock Exchange, NYSE American (formerly NYSE Amex), Nasdaq Global Market or Nasdaq Capital Market and that has eliminated cumulative voting (¶ *4:88.13*) may provide in its articles (or bylaws) that, in an "uncontested election," a director must be elected by the affirmative vote of a *majority of the shares represented and voting at the meeting.* [See Corps.C. §§ 708.5(b), 153, 301.5(d)]

1) [4:88.21] **"Uncontested election":** For purposes of Corps.C. § 708.5(a), an election is "uncontested" if, at the expiration of the time fixed under the articles or bylaws requiring advance notice of director candidates (or if there is no such articles or bylaws provision, at a time fixed by the directors not more than 14 days before notice is given of the meeting to elect directors), the number of candidates for election does not exceed the number of directors to be elected. [Corps.C. § 708.5(a)(1)]

2) [4:88.22] **Expiration of term for incumbent director who fails to receive majority vote:** If an incumbent director fails to be reelected by the required majority vote, the director's term ends on the *first* to occur of (i) the director's resignation, (ii) 90 days after the date the voting results are determined by election inspectors (Corps.C. § 707, ¶ *4:272 ff.*), or (iii) the board's election of a successor director (see Corps.C. § 305(a), ¶ *4:86, 6:215.2 ff.*). [Corps.C. § 708.5(c), (d)]

3) [4:88.23] **Comment:** As stated above (¶ *4:88.20*), the majority vote requirement in uncontested director elections is available only to listed corporations that opt out of cumulative voting and affirmatively adopt the majority vote requirement. In all other situations, directors will be elected even if, through "no" or "withheld" (abstained) votes, they receive less than a majority of the votes cast at the meeting ("plurality" voting). [See Corps.C. § 708(c), ¶ *6:107 ff.*]

[4:88.24 - 4:88.30] ***Reserved.***

(m) [4:88.31] **Staggered terms (mutual water company):** A mutual water company may adopt an article (or bylaw) provision electing directors to serve staggered four-year terms. [Corps.C. § 301.9; *see*¶ *3:148.3*]

(n) [4:89] **Other provisions regulating board procedures:** The articles (or bylaws) may contain other provisions altering the statutory standards otherwise applicable to meetings and procedures by the board of directors; e.g., such matters as notice, waivers, etc. (See various statutory standards for directors' meetings in Corps.C. § 307, *discussed at*¶ *6:188 ff.*)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

➪ [4:90] ***PRACTICE POINTER:*** However, it is rarely advisable to include such housekeeping provisions in the articles. They are much better left to inclusion in the bylaws, which are easier and less costly to change (*see*¶ *4:58*).

(o) [4:91] **Compare—*prohibited provisions relating to directors:*** Certain statutory standards relating to directors *cannot* be varied in the articles (or bylaws):

• [4:92] The articles cannot dispense with the required notice of special meetings of the board of directors. [Corps.C. § 307(a)(2); *see*¶ *6:198*]

• [4:93] The articles cannot reduce the quorum required at a board meeting below one-third of the authorized number of directors, or two directors, whichever is greater (unless there is only one shareholder, in which event only one director is necessary). [Corps.C. § 307(a)(7); *see*¶ *6:212*]

• [4:94] The articles cannot authorize board action by less than a majority of the directors present at a meeting at which a quorum exists. [Corps.C. § 307(a)(8); *see*¶ *6:221*]

• [4:95] The articles cannot require more than a majority vote or quorum to dissolve the corporation under the limited circumstances stated in Corps.C. § 1900(b); *see*¶ *6:221.1*.

• [4:95.1] The articles cannot limit directors' liability to the corporation for certain types of highly culpable misconduct (*see*¶ *6:250.6*); nor can they limit *at all* any equitable relief (e.g., injunction) that the corporation may obtain against directors. [Corps.C. § 204(a)(10); see also Corps.C. § 2603(a)(10) (SPCs, ¶ *9:43*)]

• [4:95.2] The articles cannot limit the liability of corporate *officers* for their actions as such, even if they are also directors. [Corps.C. § 204(a)(10)(C); see also Corps.C. § 2603(a)(10)(C) (SPCs)]

• [4:95.3] The articles cannot authorize indemnification of directors for certain types of egregious misconduct (*see*¶ *6:250.6*), or where indemnification is expressly prohibited by Corps.C. § 317 (*see*¶ *6:464.2*). [Corps.C. § 204(a)(11); see also Corps.C. § 2603(a)(11) (SPCs, ¶ *9:43 ff.*)]

(4) [4:96] **Optional provisions relating to shares:** As previously discussed, certain provisions regarding the shares are *required* in the articles: At a minimum, the articles must state that the corporation is authorized to issue at least one class of shares, and the number of shares in such class that it is authorized to issue. If more than one class (or series of shares within a class) is to be authorized, the articles must name each such class (or series), state the authorized number of shares therein, and the rights, preferences, privileges, and restrictions granted to or imposed upon such class (or series). [Corps.C. § 202(f), (g); see also Corps.C. § 2602(f), (g) (SPCs, ¶ *9:31 ff.*); *and*¶ *4:28*]

Aside from these required provisions, there are numerous other, *optional* provisions regarding shares that *may* be included in the articles. As will be seen, some of these are effective *only* if included in the articles. Others, however, may be included *either* in the articles or *bylaws*, or even in a separate shareholders agreement, where appropriate.

➪ [4:97] ***PRACTICE POINTER:*** As discussed earlier, where there is a choice, there may be good reasons *not* to include such restrictions in the articles (*see*¶ *4:58*).

(a) [4:98] **Shareholder qualification requirements:** The organizers are entitled to establish qualifications as to who may own shares in the corporation. But such limitations *must* be included in the articles to be effective. [Corps.C. § 204(a)(3); see also Corps.C. § 2603(a)(3) (SPCs)]

• ***FORM:*** Optional Articles Provision Establishing Shareholder Qualification Requirements, *see Form 4:A.1p*.

1) [4:99] **Comment:** Such provisions are uncommon, but might be appropriate where the organizers want to limit the investors to a particular group (e.g., members of a particular family, or a particular trade).

2) [4:100] **Compare—professional corporations:** The articles of incorporation of a professional corporation are *required* to limit share ownership to persons who are licensed professionals in the profession in which the corporation is engaged. [Corps.C. § 13406(a); *see*¶ *2:256*]

3) [4:101] **Must be shown on share certificate:** Shareholder qualification requirements are treated similarly to share transfer restrictions, and must be noted on the face of the share certificate (or the "initial transaction statement" if the corporation has adopted uncertificated shares; ¶ *5:474*). Absent such notation, they are unenforceable against any transferee without knowledge of the restriction. [Corps.C. § 418(b); see also Corps.C. § 2800(c) (SPCs); *and*¶ *5:464.1*]

(b) [4:102] **Shareholders' right to determine consideration for which shares may be issued:** Normally, the directors determine the consideration to be received by the corporation for its shares. If the organizers want to limit the directors' power in this regard, a provision may be included in the articles giving the shareholders the right to determine (or

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

approve) the consideration to be received by the corporation for any future share issuances. To be effective, such provision must be contained in the articles. [Corps.C. § 204(a)(8); see also Corps.C. § 2603(a)(8) (SPCs)]

• ***FORM:*** Optional Articles Provision Establishing Shareholders' Right to Determine Consideration for Share Issuances, *see Form 4:A.1q*.

1) [4:103] **Comment:** Such a provision is rare. It is burdensome and ordinarily not recommended—except perhaps in a small, closely-held corporation where the original investors want to protect themselves against dilution resulting from subsequent share issuances. Giving them the right to determine the amount or type of consideration to be received from future investors would provide such protection.

(c) [4:104] **Minimum price for which shares may be issued:** Although the Code does not specifically so provide, the articles apparently may specify the minimum price or consideration for which the corporation's shares may be issued.

1) [4:105] **Comment:** Under prior law, a designation of "par value" for shares would determine the minimum consideration for which such shares ordinarily could be issued. Modern law pretty well eliminates the concept of "par value" (¶ *4:47*), but there is apparently no prohibition against specifying a minimum price or consideration for which the shares may be issued.

(d) [4:106] **Shares subject to future assessment:** Corporate shares are not assessable unless the articles expressly confer authority upon the board to levy assessments. [Corps.C. §§ 204(a)(1), 423; see also Corps.C. § 2603(a)(1) (SPCs)]

• ***FORM:*** Optional Articles Provision Establishing Assessability of Shares, *see Form 4:A.1r*.

1) [4:107] **Comment:** Assessable shares are not desirable from an investor's standpoint, and it is highly unusual for a corporation to have assessable shares. However, they may be appropriate in a small, closely-held corporation, where the principals want to function like partners, and to be able to count on each other coming up with more capital if necessary. (The procedures by which the board of directors may levy and enforce an assessment are set forth in Corps.C. § 423.)

(e) [4:108] **Preemptive rights:** The organizers may want the shareholders (or any class) to have preemptive rights as to future stock issuances by the corporation, to protect their respective ownership percentages. If such rights are desired, they must be included in the articles. [Corps.C. § 204(a)(2); see also Corps.C. § 2603(a)(2) (SPCs); *and*¶ *3:180*]

• ***FORM:*** Optional Articles Provisions Granting Preemptive Rights, *see Form 4:A.1j*.

(f) [4:109] **Redemption rights:** Where more than one class of shares is authorized, shares may be made redeemable *by the corporation* under specified conditions (Corps.C. § 402(a); *see*¶ *3:131*). Also, *preferred* shares may be made redeemable at the option of the *holders*, under specified conditions. Such redemption rights must be spelled out in the articles to be effective. [Corps.C. § 402(a), (c); *see*¶ *3:136*]

• ***FORM:*** Optional Articles Provisions Granting Redemption Rights, *see Form 4:A.1g*.

[4:109.1 - 4:109.4] ***Reserved.***

(g) [4:109.5] **Conversion rights:** A corporation may issue shares convertible within the time, or on the happening of one or more events, specified in the articles. [Corps.C. § 403(a)]

1) [4:109.6] **Convertible at holder's option:** The articles may provide for shares convertible into shares of any other class or series (i) at the option of the holder or (ii) automatically upon either the vote of at least a majority of the outstanding shares of the class or series to be converted or the happening of one or more specified events. [Corps.C. § 403(a)(1)]

2) [4:109.7] **Convertible at corporation's option—"listed" corporations only:** The articles of a corporation whose stock is listed, at both the time of original issuance and the time of conversion, on the New York Stock Exchange, NYSE American (formerly NYSE Amex), the Nasdaq Global Market or Nasdaq Capital Market may authorize issuance of shares convertible at the corporation's option into any of its other classes of stock or securities, so long as the securities received upon conversion are likewise listed. [Corps.C. §§ 301.5(d), 403(a)(3)]

3) [4:109.8] **Compare—conversion of debt securities:** In contrast to convertible *shares*, convertible *debt* does *not* require an authorizing provision in the articles. A corporation may issue its debt securities convertible into other debt

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

securities or previously authorized shares within such time, upon the happening of one or more specified events, and upon such terms and conditions *as are fixed by the board of directors*. (But the articles may prohibit or otherwise restrict the board in issuing convertible debt.) [Corps.C. § 403(b)]

FORM: Optional Articles Provisions Granting Conversion Rights, *see Form 4:A.1h*.

(h) [4:110] **Reduced shareholder quorum:** Normally, a majority of the shares entitled to vote is required to be present, in person or by proxy, to constitute a quorum at a shareholders' meeting (Corps.C. § 602, *see*¶ *6:116*). However, if the organizers so desire, the articles may *reduce* the required quorum to *not less than one-third* of the shares entitled to vote at the meeting. [Corps.C. § 602(a)]

1) [4:111] **Comment:** A reduced quorum provision may be desirable where there are a large number of widely-scattered shareholders, and difficulties are anticipated in obtaining duly-executed proxies.

2) [4:112] **Compare—articles may not increase shareholder quorum requirements:** Normally, the articles may *not* require more than a majority of the shares entitled to vote to constitute a quorum at a shareholders' meeting. (This is to prevent “hold outs” from blocking shareholder action.) [Corps.C. § 602(a)]

a) [4:113] **Exception:** A *statutory close corporation* may provide, by the articles or in the shareholders agreement, for a *greater*-than-majority quorum for shareholders' meetings. [Corps.C. §§ 602(a), 300(b), (c)]

(i) [4:114] **Shareholder action by more than majority:** As with action by the directors (¶ *4:83*), the articles may require approval by a supermajority vote (up to 100%) of the shares or any class of shares to constitute valid shareholder action. To be effective, such provision must be contained in the articles. [Corps.C. § 204(a)(5); see also Corps.C. § 2603(a)(5) (SPCs)]

• ***FORM:*** Optional Articles Provision Requiring Supermajority Vote of Shareholders, *see Form 4:A.1s*.

1) [4:115] **Comment:** Such provisions are most commonly encountered in small, closely-held corporations, where the organizers want to provide protections for minority shareholders.

➪ [4:115.1] ***PRACTICE POINTER:*** Such a provision may be difficult to get rid of because it can be amended or repealed only by supermajority vote *unless the articles permit a lesser vote*. [Corps.C. § 902(e); *see* ¶ *8:60*]

2) [4:115.2] **Limitations on supermajority amendments by corporations with 100 or more shareholders:** Corporations with outstanding shares held of record by *100 or more persons* are subject to special statutory restrictions on the right to file an articles amendment containing a supermajority vote provision (Corps.C. § 710(a)):

a) [4:115.3] **66-2/3% ceiling:** The articles of such corporation may not be amended to require supermajority approval *in excess of 66-2/3%* of the outstanding shares (or the outstanding shares of any class or series). [Corps.C. § 710(b)]

b) [4:115.4] **Approval of amendment:** Further, the amendment calling for a super-majority vote requirement must be approved by at least the same supermajority vote as specified in the amendment to approve other corporate actions (again, not exceeding 66-2/3%). [Corps.C. § 710(c)]

[4:115.5] ***Reserved.***

c) [4:115.6] **Exemption for “nonpublic” corporations with multiple classes of stock:** The above limitations do *not* apply to a corporation that files an articles amendment *on or after January 1, 1994* if, at the time of filing, it has:

• more than one class or series of outstanding shares;

• no class of equity securities registered under SEA § 12; and

• fewer than 300 record holders of all of its outstanding securities. [Corps.C. § 710(a)]

1/ [4:115.6a] **Comment:** A corporation meeting this exemption may adopt a supermajority vote requirement (or increase an existing requirement) beyond 66-2/3%. However, the exemption does *not* affect a controlling shareholder's *fiduciary duties* to minority shareholders (¶ *6:342 ff.*). [See Corps.C. § 710(d)] A supermajority vote requirement that freezes out, and consequently causes damage to, minority shareholders may give rise to a common law action for breach of fiduciary duty.

d) [4:115.7] **Compare—pre-1989 super-majority provisions:** Supermajority vote requirements in place *before January 1, 1989* are not affected by the § 710 limitations and thus remain valid without restriction regardless of the number of outstanding record shares. [Cf. Corps.C. § 710(a)]

3) [4:116] **Matters not subject to super-majority approval requirement:** There are some matters as to which the articles may not require a higher percentage of shareholder approval than required by statute:

a) [4:117] **Election of directors:** The articles may not require a greater number of shares for election of directors than is required under the statutes providing for cumulative voting for directors. [Corps.C. §§ 204(a)(5), 708(c); see also Corps.C. § 2603(a)(5) (SPCs); *and*¶ *3:145*]

(An exception is made for "listed" corporations whose articles or bylaws have been amended to eliminate cumulative voting. Corps.C. § 301.5; *see*¶ *4:88.13 ff.*)

b) [4:118] **Removal of directors:** Likewise, to protect cumulative voting rights, the articles may not require a larger shareholder vote to remove or retain directors than required by statute. (A director cannot be removed from office without cause if the shares voting against their removal would be sufficient to elect them to office under cumulative voting. This is so *even* in the case of "listed" corporations that have eliminated cumulative voting and established a "classified" board.) [Corps.C. §§ 204(a)(5), 303(a)(1)-(3), (c); see also Corps.C. § 2603(a)(5) (SPCs); *and*¶ *4:88.13 ff., 6:20 ff.*]

c) [4:119] **Voluntary dissolution:** Nor can the articles increase the shareholder vote required for *voluntary dissolution* of the corporation beyond that required by statute (50% or more of the voting power; see Corps.C. § 1900(a), ¶ *8:753*). [Corps.C. § 204(a)(5); see also Corps.C. § 2603(a)(5) (SPCs)]

Exception: If preferred shares are given the right to approve dissolution, the articles may require approval by up to *two-thirds* of the preferred, instead of a mere 50%; see Corps.C. § 402.5(b).

(j) [4:120] **More or less than one vote per share:** Each outstanding share, regardless of class, is normally entitled to one vote on each matter submitted to a vote of shareholders. However (as long as one class or series has full voting rights), the articles may provide for more or less than one vote for any share on any matter. [Corps.C. §§ 700(a), 112]

(This does not apply, however, to the election of directors by cumulative voting; *see discussion at*¶ *3:145 ff.*)

(k) [4:121] **Class voting for directors:** To provide certain groups of shareholders with greater representation on the board of directors, the organizers may want *class voting* to elect a "classified board"—i.e., one or more directors are elected by a specific class or series of shares, *voting as a class or series*. If this is desired, appropriate provisions must be included in the articles. [Corps.C. § 301(a); *see*¶ *3:155*]

• ***FORM:*** Optional Articles Provision Creating "Classified Board," *see Form 4:A.1t*.

(*l*). [4:122] **Shareholder approval for particular board actions ("veto" power):** Shareholder approval is required by statute for certain fundamental changes in the corporate structure; e.g., mergers, dissolution, articles amendments, etc. (*see Ch. 8*). The organizers may want the shareholders to have the right to approve other matters as well—i.e., matters that otherwise would be within the exclusive discretion of the directors.

Common examples: Shareholder approval for *executive compensation* (*see*¶ *6:391*) or for *encumbering corporate assets* (*see*¶ *8:600*). If the shareholders are to have such "veto" power, it must be provided in the articles; otherwise, such matters rest within the exclusive discretion of the board. [Corps.C. §§ 204(a)(9), 1000; see also Corps.C. § 2603(a)(9) (SPCs)]

• ***FORM:*** Optional Articles Provision Requiring Shareholder Approval for Specified Actions, *see Form 4:A.1u*.

1) [4:123] **Comment:** This type of provision is normally utilized only in closely-held corporations.

2) [4:124] **Drafting considerations:** Where such a provision is utilized, the matters the shareholders are granted the right to approve should be specifically delineated in order to avoid ambiguities in the allocation of responsibility between the directors and the shareholders for corporate actions.

3) [4:125] **"Shareholder approval":** The provision should also specify whether approval is required by "*holders of outstanding shares*" (meaning a majority of the outstanding shares entitled to vote); or simply by the "*shareholders*" (meaning a majority of those present and voting at a shareholders' meeting at which a quorum is present). [See Corps.C. §§ 152, 153, *discussed at*¶ *6:7*]

4) [4:126] **No effect on third parties dealing with corporation:** Provisions in the articles requiring shareholder approval of board action *cannot* be asserted by the corporation or any shareholder to defeat the rights of third parties dealing with the corporation—i.e., such third parties can enforce contracts with or conveyances from the corporation notwithstanding the shareholders' failure to approve same. [See Corps.C. § 208(a)]

• [4:126.1] **Comment:** It is not clear, however, whether this rule applies where the third party had knowledge that shareholder approval was required and had not been obtained. Arguably, under some circumstances, an equitable estoppel may be invoked to prevent third parties from asserting defects of which they had knowledge when they dealt with the corporation.

(m) [4:127] **Ban on shareholder action by written consent:** Any action that can be taken at a shareholders' meeting can ordinarily be taken without a meeting by written consent of a sufficient number of shareholders (Corps.C. § 603(a); *see¶ 6:154*). If the organizers want to restrict or prevent this, such restriction must appear in the articles in order to be effective. [Corps.C. § 603(a)]

• [4:127.1] **Comment:** Such provisions are rare in private companies, because shareholder action by written consent is often the favored alternative to formal shareholders' meetings. But there is a drawback in that minority shareholders may not be consulted or notified as to many shareholder actions until after the action has been taken by the majority (*¶ 6:166*). If this drawback is deemed sufficiently important by the organizers, the articles should be drafted to prohibit shareholder action by written consent.

(n) [4:128] **Waiving certain statutory protections for preferred shares:**Corps.C. § 500 prohibits dividends to junior shareholders that might endanger the dividend or liquidation preferences on outstanding preferred shares. If the organizers want to avoid these restrictions, they may do so, but the articles must expressly so provide. *See¶ 7:21 ff.*

(o) [4:129] **Prohibiting reissuance of reacquired shares:** When a corporation redeems or repurchases its own shares (or otherwise reacquires them—e.g., by conversion from one class to another), they are automatically restored to the status of authorized but unissued shares and therefore may be reissued. [Corps.C. § 510(a), (d)]

However, the articles may prohibit such reissuance, either by a *blanket prohibition* on the reissuance of shares of a class or series or by specifically prohibiting the reissuance of shares of a series *as shares of that same series*. [Corps.C. § 510(b), (c)]

1) [4:130] **Effect—reduction of capital upon reacquisition:** If the articles do prohibit reissuance of shares, then upon reacquisition by the corporation, the authorized number of shares of the class (or series) to which such shares belong is *reduced* by the number of shares so acquired. [Corps.C. § 510(b), (c); *see¶ 7:140 ff.*]

Moreover, the *articles must be amended to reflect such reduction* in authorized shares. A certificate of amendment must be filed with the Secretary of State, documenting the reduction or elimination of the previously authorized number of shares. No shareholder approval is required to adopt such amendment. [See Corps.C. § 510(b), (c), (f); *¶ 8:70*]

(p) [4:131] **Transfer restrictions:** If it is desired to restrict the shareholders' right to transfer or hypothecate their shares, appropriate restrictions may be provided in the articles *or* bylaws, *or* in a separate shareholders agreement. [Corps.C. §§ 204(b), 212(b)(1); see also Corps.C. § 2603(b) (SPCs); *and ¶ 3:201.1 ff.* re securities law considerations when modifying transfer restrictions contained in "organizational documents"]

1) [4:132] **Restrictions must be "reasonable":** However, if transfer restrictions are included in the articles or bylaws, they must be "reasonable." [Corps.C. § 204(b); see also Corps.C. § 2603(b) (SPCs)]

The principal issue is whether the restrictions are so arbitrary as to constitute an "unreasonable restraint on alienation."

a) [4:133] **Right of first refusal:** A provision giving the corporation (or other shareholders) the right to purchase the shares at the same price an outsider is offering to pay for them, is undoubtedly valid.

b) [4:134] **Right to purchase at fixed price:** However, it is an open question whether a right to purchase is reasonable where the corporation (or other shareholders) is given the right to purchase at the price at which the stock was originally sold or at some other *fixed price not subject to adjustment* to reflect increases in value … although such an arrangement is apparently enforceable if established by *contract* among the shareholders. [See *Cutter Laboratories, Inc. v. Twining* (1963) 221 CA2d 302, 311, 34 CR 317, 325; see also *Tu-Vu Drive-In Corp.*

v. Ashkins (1964) 61 C2d 283, 288, 38 CR 348, 351; and *Yeng Sue Chow v. Levi Strauss & Co.* (1975) 49 CA3d 315, 329,122 CR 816, 824]

2) [4:135] **No retroactive effect:** Even if "reasonable," such restrictions may be valid only with respect to shares issued *after* the adoption of such provision. Such restrictions are not binding as to shares issued previously unless the holders of such shares voted in favor of the restriction. [Corps.C. § 204(b); see also Corps.C. § 2603(b) (SPCs)]

3) [4:136] **Must appear on share certificate:** To be effective, any such restriction must appear on the face of the share certificate (or "initial transaction statement" if the corporation adopts uncertificated shares; ¶ *5:474*); otherwise, third parties can take free of the restriction. [Corps.C. § 418(a)(1); see also Corps.C. § 2800(b)(1) (SPCs); *and*¶ *5:464.1*]

(q) [4:136.1] **Shareholder buy-out provisions to govern upon dissolution:** If the shareholders plan to have a "buy-out agreement" (*see*¶ *3:187 ff.*) and want its provisions to govern upon dissolution, the articles must expressly so provide. Otherwise, the *statutory* buy-out procedures may control when the corporation dissolves (*see*¶ *3:232.3*).

• ***FORM:*** Optional Articles Provision Establishing Primacy of Buy-Out Agreement Upon Dissolution, *see Form 4:A.1v*.

(r) [4:136.2] **Blockchain technology for share issuance and transfers:** California statutory authority allowing certain corporations to include provisions in their articles authorizing shareholder records to be kept by means of "blockchain technology" was repealed effective January 1, 2022. [See former Corps.C. §§ 204(a)(12), 2603(a)(12) (Stats. 2018, Ch. 889; repealed eff. 1/1/22)]

1) [4:136.3] **Compare—Delaware law:** Delaware permits the use of blockchain technology (referred to as "distributed electronic networks or databases") in connection with corporate records generally, including stock ledgers. [8 Del.C. § 224]

(s) [4:137] **Compare—*prohibited provisions relating to shares and shareholders:*** Neither the articles nor bylaws may alter the standards set by the Corporations Code with respect to the following matters:

1) [4:138] **Redemption of common stock:** The articles may not make *common* shares redeemable at the option of the holder, if there is no other class of non-redeemable shares outstanding. [Corps.C. § 402(c); *see*¶ *3:132*]

(Even so, the same result can be reached by having the corporation execute a written *agreement* to repurchase such shares upon specified terms and conditions at the shareholders' demand; provided, of course, that the corporation at that time has the legal capacity to repurchase its shares … see limitations in Corps.C. §§ 500-511, ¶ *7:10 ff.*)

2) [4:139] **Converting shares into debt:** Shares may not be made convertible into debt securities, although the articles can provide for shares convertible into shares of any other class or series, or for the issuance of debt securities convertible into other debt securities or into shares of the corporation. [Corps.C. § 403]

a) [4:139.1] **Exception for "listed" corporations:** An exception is made for a corporation with shares listed on the New York Stock Exchange, the NYSE American (formerly NYSE Amex), the Nasdaq Global Market or the Nasdaq Capital Market, provided that any securities into which the shares are converted are also so listed (or qualified for listing). [Corps.C. §§ 301.5(d), 403(a)(3)]

3) [4:140] **Eliminating shareholder approval as to certain transactions:** The articles may not restrict or deny the rights of any class of shares to approve corporate transactions which the Code requires to be approved by such shareholders voting by class (e.g., amendments affecting preferences or priorities of that class). [Corps.C. § 117]

4) [4:141] **Changing shareholder quorum requirements:** The articles may neither increase the quorum required at a shareholders' meeting, nor reduce the quorum to less than one-third of the shares entitled to vote at the meeting. [Corps.C. § 602(a), ¶ *6:118*]

5) [4:142] **Changing cumulative voting for directors:** To protect cumulative voting rights, the articles may not require a supermajority shareholder vote for election of directors or their removal without cause. [Corps.C. §§ 708, 303(a); ¶ *6:136*] (Again, an exception is made for the *election* of directors of "listed" corporations that have eliminated cumulative voting. Corps.C. § 301.5; *see*¶ *4:88.13 ff.*)

6) [4:143] **Increasing vote required for voluntary dissolution:** The articles may not require more than 50% of the shares to effect a voluntary dissolution of the corporation (except where preferred shares are given the right to approve such a dissolution, the articles may require up to two-thirds approval). [See Corps.C. §§ 1900, 204(a)(5) and 402.5(b); see also Corps.C. § 2603(a)(5) (SPCs); *and*¶ *8:754*]

(5) [4:144] **Optional provisions relating to debt holders (granting voting rights to debt holders):** The organizers may wish to confer upon the holders of corporate bonds or other debt securities the right to vote in the election of directors

and on any other matters on which shareholders may vote. If so, appropriate provisions must be included in the articles of incorporation to be effective. [Corps.C. § 204(a)(7); see also Corps.C. § 2603(a)(7) (SPCs)]

(a) [4:145] **Comment:** Such provisions are rare. This is because creditors ordinarily do not *want* active involvement in the corporation's activities, or to vote in the election of directors. They are usually more concerned with assuring the corporation's ability to meet its repayment obligations to them. Consequently, creditors usually demand control over the corporation's activities in the form of protective covenants in their loan agreements (restricting dividends, investments, etc.), rather than the taking of voting rights as such. Alternatively, they may want the right to *convert* their debt into voting shares.

(6) [4:145.1] **Optional provisions authorizing expanded indemnification for corporate agents:** If the articles so provide, the corporation may indemnify its directors, officers and other agents to a greater extent than permitted by Corps.C. § 317 (*see¶ 6:470.3 ff.*). [Corps.C. § 204(a)(11); *¶ 4:88.8 ff.*; *but see¶ 9:44 re SPCs*]

• ***FORM:*** Optional Articles Provision Authorizing Expanded Indemnification of Corporate Directors, Officers and Agents, *see Form 4:A.1**o***.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 4-B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

B. Executing and Filing the Articles

1. [4:146] Execution of Articles by Incorporators and Initial Directors
  a. [4:149] Signatures required
  b. [4:152] Acknowledgments required if named directors sign articles
    (1) [4:153] Notarial acknowledgment
    (2) [4:154] Acknowledgment by declaration
  c. [4:156] Execution must appear on single document
  d. [4:158] Dating the articles
2. [4:159] Filing Articles With Secretary of State
  a. [4:160.1] Form ARTS-GS
  b. [4:161] How to file articles
    (1) [4:161.1] Mail or hand delivery
    (2) [4:161.2] Online filing
  c. [4:162] Filing fees and required minimum franchise tax payment
    (1) [4:163] Includes one copy
    (2) [4:164] Franchise tax prepayment eliminated
    (3) [4:164.1] Payment by dishonored check
3. [4:165] Effective Date of Filing
4. [4:167] Where Filing Refused on Grounds Articles Do Not Conform to Law
  a. [4:168] Resubmission with opinion of counsel

1. [4:146] **Execution of Articles by Incorporators and Initial Directors:** The articles of incorporation must be signed by each of the incorporators—including each initial director who is named in the articles (¶ 4:149). [Corps.C. § 200(a), (b); see also Corps.C. § 2600(b) (SPCs)]

[4:147] As discussed earlier, any natural person, partnership, association or corporation (domestic or foreign) may serve as an incorporator. Only one incorporator is required to form a corporation; although any number is permitted. [Corps.C. § 200(a); see also Corps.C. § 2600(a) (SPCs); *and ¶ 3:418 ff.*]

[4:148] It is not necessary to name the initial directors in the articles. [Corps.C. § 204(c); see also Corps.C. § 2603(c) (SPCs); *and ¶ 4:68*] But any initial directors who *are* named are deemed incorporators; and they must both sign *and acknowledge* the articles in their capacities as directors and incorporators.

a. [4:149] **Signatures required:** Each incorporator and each initial director named in the articles must sign the same original articles of incorporation. [Corps.C. § 200(a); see also Corps.C. § 2600(b) (SPCs)]

[4:150] Signatures must be personal signatures; signatures by agents or appointees are *not* acceptable.

However, *facsimile* signatures are permitted. (The person whose signature is affixed by fax must maintain the *originally-signed document* for at least *five years* from the date of *filing*.) [Corps.C. § 17.1(a)-(d)]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[4:151] A partnership, association or corporation may act as an incorporator. In that event, the signature would be in the name of the entity followed by a line for the officer or person authorized to sign on its behalf, showing their name and title.

b. [4:152] **Acknowledgments required if named directors sign articles:** The signature of each initial director named in the articles must also be duly acknowledged—either before a notary public or by declaration. [Corps.C. § 149]

(1) [4:153] **Notarial acknowledgment** consists of having a notary affix a certificate and seal to the articles stating in effect that the initially named director appeared before the notary and identified themselves and their signature. [Civ.C. §§ 1180-1207]

It may be acknowledged before a notary public in another state (or a judge or clerk of a court of record having an official seal). No further evidence of authentication is required. [Corps.C. § 149]

(2) [4:154] **Acknowledgment by declaration** is simply a declaration in writing by the incorporators and/or directors stating that they are the persons identified in the articles, and that the articles are their act and deed. [Corps.C. § 149(b)] (Note: The declaration need *not* state the date or place of its execution; nor need it be made under penalty of perjury.)

• ***FORM:*** Articles Designating Initial Directors, *see Form 4:A.3*.

➪ [4:155] ***PRACTICE POINTER:*** The declaration form is highly recommended because of its greater ease and convenience. It can be used whether the articles are executed in California or elsewhere, and avoids the inconvenience of having to appear before a notary public.

c. [4:156] **Execution must appear on single document:** All signatures and acknowledgments (whether original or facsimile) must appear on the *same* articles of incorporation—the original to be filed with the Secretary of State. Execution on separate counterparts is not allowed. [See Corps.C. § 200(b); see also Corps.C. § 2600(b) (SPCs)]

➪ [4:157] ***PRACTICE POINTER:*** This usually requires having all of the incorporators (or all the initially named directors) present at the same time and place, or having the original articles transmitted from one to the other for execution.

This is one reason why many practitioners prefer to use a single incorporator, rather than naming the entire initial board of directors in the articles.

It is also another reason for using the acknowledgement by declaration form (¶ *4:154*) where directors execute the articles—i.e., no notary need be present.

d. [4:158] **Dating the articles:** There is no requirement that the articles set forth the date of their execution, although it is common practice to do so. Neither the date set forth, nor the actual date of execution, however, has any legal significance. Only the date of "filing" has legal effect (*see ¶ 4:159*).

2. [4:159] **Filing Articles With Secretary of State:** Filing of the articles by the Secretary of State is the crucial event in commencing corporate existence. The corporation springs into life *automatically* when its articles are filed. (However, the corporation is only a "shell" until its board of directors takes further steps to complete its organization by appointing officers, issuing shares, etc.) [Corps.C. § 200(c); see also Corps.C. § 2600(c) (SPCs)]

[4:160] A certified copy of the articles is *conclusive* evidence of the formation of the corporation for all purposes (except a proceeding by the state in the nature of quo warranto). Moreover, it is prima facie evidence of the corporation's continued existence. [Corps.C. § 209]

a. [4:160.1] **Form ARTS-GS:** The Secretary of State has created a relatively simple form of articles of incorporation, Form ARTS-GS, which is available on the Secretary of State's website (*www.sos.ca.gov*).

Form ARTS-GS offers a straightforward alternative for providing the information that must be included in an articles of incorporation. However, any form of articles may be used, as long as the form meets the statutory requirements for articles of incorporation. [*See* ¶ 4:3 ff.]

Form ARTS-GS may be filed physically (¶ 4:161.1), but only in the Secretary of State's Sacramento office. An electronic version of Form ARTS-GS can also be filed online (¶ 4:161.2) through the Secretary of State's website (*www.sos.ca.gov*).

b. [4:161] **How to file articles:** After the articles have been prepared, executed and acknowledged, the original articles (together with copies to be certified and returned) should be forwarded to the Secretary of State, accompanied by payment of the applicable fees (¶ 4:162).

(1) [4:161.1] **Mail or hand delivery:** The articles may be delivered to the Sacramento office of the Secretary of State by *mail* (Business Entities Filing Unit, P.O. Box 944260, Sacramento, CA 94244-2260) or by *hand* (1500 11th Street, 3rd Floor, Sacramento, CA 95814).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

In addition, articles (other than those containing a statement of conversion) may be delivered by hand to the Secretary's branch office in Los Angeles (*see ¶ 3:413 for address*).

(2) [4:161.2] **Online filing:** Effective March 27, 2020, incorporators may file articles of incorporation online by submitting an electronic version of Form ARTS-GS (¶ 4:160.1) on the Secretary of State's website (*www.sos.ca.gov*).

The incorporator signs the form electronically and checks a box acknowledging that they are signing the document as the incorporator of the corporation and that all information provided on the form is true and correct.

The filing and certified copy fees (¶ *4:162 ff.*) are paid online by credit card when the form is submitted.

➪ [4:161.3] ***PRACTICE POINTER—EXPEDITED FILING SERVICE*:** Articles (and other documents) submitted by mail for filing in the Sacramento office are generally processed in 10 to 20 business days. For payment of an additional fee, various levels of expedited service are available, including same-day service for documents submitted in person to the Sacramento office. These expedited services are described on the Secretary of State's website (*www.sos.ca.gov*). [See 2 CCR §§ 21903-21905]

c. [4:162] **Filing fees and required minimum franchise tax payment:** A fixed fee of $100 is required to file the original articles and should be paid by check or money order payable to the Secretary of State. [Gov.C. § 12186(c)] (If the articles are hand delivered to the Sacramento or Los Angeles office (¶ *4:161.1*), an additional $15 special handling fee is charged; see Gov.C. § 12182; 2 CCR § 21903(c).)

(1) [4:163] **Includes one copy:** Upon filing the articles, the Secretary of State will provide a copy without additional charge. Additional copies can be certified at a cost of $5 each. [Gov.C. §§ 12183, 12185]

(2) [4:164] **Franchise tax prepayment eliminated:** Corporations are exempt from the annual $800 minimum franchise tax for their *first taxable year*. [Rev. & Tax.C. § 23153(f)(1); *see* ¶ *2:102.3*]

Hence, there is no requirement that the minimum tax be paid upon incorporation.

(3) [4:164.1] **Payment by dishonored check:** If a check accepted in payment of the above (¶ *4:162*) filing fees does not clear ("bounces"), the Secretary of State, within 90 days after receiving written notification of the dishonored check, may give written notice of *cancellation* of the filing. The notice must be mailed to the agent for service of process or person submitting the check at least 20 days before the specified cancellation date. Cancellation can be avoided by paying with a cashier's check or equivalent before the specified cancellation date. [Corps.C. § 110.5]

3. [4:165] **Effective Date of Filing:** The effective date of filing is the date the articles are *received* by the Secretary of State, provided they conform to law and are acceptable for filing. However, the organizers may request filing on a specified future date (which may not be more than 90 days after the articles are received, including Saturdays, Sundays and legal holidays). [Corps.C. § 110(a); see *Roman Catholic Bishop of San Jose v. Bowen* (2013) 219 CA4th 484, 487, 162 CR3d 32, 34—Secretary of State may refuse to file articles that do not conform to law (decided under statutory provision comparable to § 110(a))]

[4:166] ***Reserved.***

4. [4:167] **Where Filing Refused on Grounds Articles Do Not Conform to Law:** If, upon review of the articles as submitted for filing, the Secretary of State determines that they do not conform to law and returns them, the person submitting the articles will be informed by telephone or letter.

a. [4:168] **Resubmission with opinion of counsel:** If the articles are returned by the Secretary of State unfiled as not conforming to the legal requirements for filing, they may be resubmitted accompanied by a written opinion of a member of the State Bar of California to the effect that the specific provision(s) of the articles objected to by the Secretary of State does conform to law, and setting forth the points and authorities on which such opinion is based. Such opinion of counsel may be given either by the attorney submitting the articles, or by an attorney representing the person submitting the articles.

Except where the refusal to file is based upon the choice of corporate name, the Secretary of State will rely on the written opinion of counsel in determining whether the articles conform to law and will then file the articles. The date of filing in such case is the date the articles are received upon such resubmission. [Corps.C. § 110(b)]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 4-C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

C. Immediate Postfiling Steps and Planning

1. [4:170] Corporate Kit

[4:169] Once the articles of incorporation have been prepared and forwarded to the Secretary of State for filing, counsel's next responsibilities usually are:

• Ordering or preparing internally the corporate kit, consisting of the corporate minute book and share certificates (*¶ 4:170*);

• Preparing the bylaws (*¶ 4:171 ff.*);

• Preparing for, and assisting with, the initial organizational meeting of the directors (including arranging for appointment of the initial directors when not named in the articles; *¶ 4:398 ff.*); and

• Implementing the organization of the corporation, including the initial issuance of shares, and compliance with applicable securities laws (*¶ 5:1 ff.*).

1. [4:170] **Corporate Kit:** With the availability of word processing and color printers, counsel now will often prepare a minute book and the corporation's stock certificates and stock ledger in-house, rather than order a "corporate kit" containing these items (and a corporate seal) from a third-party vendor. Since share certificates (and corporate seals, if ordered) typically bear the corporation's date of incorporation, these items are not prepared (or ordered) until the date of incorporation is known—i.e., until after the articles have been filed.

Although a corporate seal no longer has any legal significance in California (*see ¶ 4:433*), a hand seal is sometimes ordered and used as a matter of tradition and to satisfy banks and other financial institutions that may from time to time request that the corporate seal be affixed to corporate documents (even though this exercise is no longer required under the Corporations Code).

(Form minutes and bylaws may also be purchased in connection with corporate kits; however, they should be used with great caution; *see ¶ 4:188*.)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 4-D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

D. Preparing Bylaws

1. [4:171] Bylaws Generally Not Required by Law
    a. [4:172] Exception where number of directors not stated in articles
2. [4:173] Purposes of Bylaws
    a. [4:174] To provide "housekeeping" rules
    b. [4:175] To recite statutory standards
    c. [4:176] To vary statutory standards
3. Procedural Considerations
    a. [4:177] Adoption, amendment and repeal of bylaws
        (1) [4:178] By incorporators before election of initial directors
            (a) [4:179] Required where directors not named in articles
        (2) [4:180] By board of directors
            (a) [4:181] Articles or bylaws may restrict board's power
            (b) [4:182] Restriction on change in number of directors
            (c) [4:183] Restriction on filling vacancies on board resulting from removal of directors
        (3) [4:184] By shareholders
    b. [4:185] Maintaining bylaws
    c. [4:186] Shareholders' right to inspect bylaws
4. Drafting Considerations—In General
    a. [4:187] Whether to adopt or vary statutory standards
    b. [4:188] Caution re using "model" bylaws
    c. [4:189] Certain bylaws PROHIBITED
        (1) [4:191] Bylaws prohibited by statute
        (2) [4:193] Matters reserved exclusively to articles
        (3) [4:194] Bylaws conflicting with articles
        (4) [4:195] Bylaws inherently unfair or unreasonable
5. [4:196] Particular Bylaw Provisions
    a. Bylaws governing shareholders' meetings and action
        (1) [4:198] Place of shareholders' meetings
        (2) [4:199.5] Virtual shareholder meeting requirements
            (a) [4:199.6] Requirements for virtual meetings
            (b) [4:199.8] "Electronic transmission by and to the corporation" defined
                1) [4:199.9] Consent and notice requirements for electronic transmissions *by* corporations

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [4:199.10] Disclosure required for electronic transmissions to individual shareholders
2) [4:199.11] Compare—electronic transmissions *to* corporations
(3) [4:200] Date of annual meeting of shareholders
(a) [4:202] Remedy for failure to hold annual meeting
(4) Special meetings of shareholders
(a) [4:203] Who may call special meetings
(b) [4:205] Procedures for calling special shareholders' meetings
1) [4:206] Written request, specifying general nature of business to be transacted
2) [4:207] Delivery of request to corporation
(c) [4:208] Obligation of corporation to comply with request for special meeting
1) [4:209] Remedy for failure to comply
2) [4:210] Access to mailing list of shareholders
(5) [4:211] Notice of shareholders meeting
(a) [4:212] How much notice required
(b) [4:213] Manner of giving notice
1) [4:214] Address problems
a) [4:215] Comment
2) [4:216] Time notice deemed given
3) [4:216.1] Electronic notices
a) [4:216.2] Notices during emergency
b) [4:216.3] Inability to send electronically
(c) Content of notice
1) [4:217] Time, date, place
2) [4:217.1] Virtual or remote participation
3) [4:218] Management nominees for election as directors
4) [4:219] Business to be transacted—annual meetings
5) [4:221] Business to be transacted—special meetings
a) [4:222] Comment
(d) [4:223] Waiver of notice
1) [4:224] By attending meeting *without* objecting
2) [4:225] By written waiver before or after meeting
a) [4:226] Waiver need not disclose matters to be acted upon
b) [4:227] Exceptions
(6) [4:228] Shareholder action *without* meeting by written consent
(a) [4:229] *Caution*—unanimity ordinarily required for election of directors by written consent
(b) [4:230] Bylaws may not restrict right
(c) [4:230.5] Electronic consent permitted
(d) [4:231] Notice required to nonconsenting shareholders
1) [4:232] Matters requiring notice *before* action taken
a) [4:232.1] Application to SPCs?
(e) [4:233] Revoking written consent
(f) [4:234] Special form of consent required where at least 100 shareholders of record
(7) [4:235] Record date for shareholder notice or action
(a) [4:236] Board authorized to fix record date
(b) [4:237] Where no record date fixed by board
1) [4:238] For shareholders' meeting
2) [4:239] For action by shareholder consents
3) [4:240] For any other purpose

- (8) [4:241] Quorum for shareholders' meetings
    - (a) [4:242] Bylaws may not vary statutory standard
    - (b) [4:243.5] Shareholders present by electronic means
    - (c) [4:244] Where no quorum at outset
        - 1) [4:245] When notice of adjournment required
    - (d) [4:246] Loss of quorum at meeting
        - 1) [4:247] Examples
- (9) [4:248] Proxies
    - (a) [4:249] Statutory right cannot be eliminated
    - (b) [4:250] Form of proxy
        - 1) [4:250.1] Telephone proxies
        - 2) [4:250.2] Written/electronic proxies
    - (c) [4:251] Presumption favoring validity of proxies
    - (d) [4:252] Duration of proxy
    - (e) [4:253] Revocability of proxies
        - 1) [4:254] Revocation by maker of proxy
        - 2) [4:255] Revocation upon death, incapacity of maker
        - 3) [4:256] When irrevocable
        - 4) [4:257] "Irrevocable" proxy may be revoked by transfer of shares
    - (f) [4:259] Special proxy form required for corporations with at least 100 shareholders
    - (g) [4:261] Federal proxy solicitation rules
- (10) [4:262] Shareholder voting procedures
    - (a) [4:263] Voting rights per share
    - (b) [4:265] Voting only part of shares
    - (c) [4:265.1] Voting by video or electronic means
    - (d) [4:266] Required vote for shareholder action
        - 1) [4:267] When supermajority vote required
    - (e) [4:269] Voting by fiduciaries, etc.
        - 1) [4:270] Comment
    - (f) [4:271] Voting pursuant to shareholder agreement
- (11) [4:272] Election inspectors
    - (a) [4:273] Number of inspectors
    - (b) [4:274] Function of election inspectors
    - (c) [4:275] Good faith requirement

b. Bylaw provisions relating to directors
- (1) [4:276] Fixing number of directors (*required* where articles silent)
- (2) [4:278] Special qualifications for directors
    - (a) [4:278.1] "Independence" requirements for directors of "listed" corporations
    - (b) [4:278.2] Female director requirements for "listed" corporations
        - 1) [4:278.2a] "Publicly held" defined
        - 2) [4:278.2b] "Female" director defined
        - 3) [4:278.2c] Minimum number of female directors after 2021
        - 4) [4:278.2d] Regulations; potential fines for noncompliance
            - a) [4:278.2e] "Violation" defined
        - 5) [4:278.2f] Pending constitutional challenges
    - (c) [4:278.3] Directors from underrepresented communities; requirements for "listed" corporations
        - 1) [4:278.3a] "Publicly held" defined
        - 2) [4:278.3b] "Director from an underrepresented community" defined
        - 3) [4:278.3c] Minimum number of directors from underrepresented communities

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

4) [4:278.3d] Regulations; potential fines for noncompliance
a) [4:278.3e] "Violation" defined
5) [4:278.3f] Pending constitutional challenges
(3) [4:279] Duties and compensation
(4) [4:280] Powers of directors
(a) [4:281] Exception in case of statutory close corporation
(b) [4:282] Board may delegate management
(c) [4:283] Board committees
1) [4:284] How committees established
2) [4:285] Powers delegable to committees
3) [4:286] Requirements and procedures for committee meetings
4) [4:286.1] Requirements imposed on "*listed*" corporations
(5) [4:287] Time of annual election of directors
(6) [4:287.6] Staggered terms (mutual water companies)
(7) [4:288] Removal of directors from office
(8) [4:291] Filling vacancies on the board of directors
(a) [4:292] Filling vacancies due to death or resignation
(b) [4:293] Vacancies due to removal of director
(c) [4:294] Shareholders may fill other vacancies not filled by directors
(d) [4:295] Right of shareholders to elect entire board where majority of directors have not been elected by shareholders
(9) [4:296] Matters relating to board meeting
(a) [4:297] How meetings are called
(b) [4:298] Place of meetings
1) [4:299] Board meeting by telephone, electronic or video conference
a) [4:299.1] Telephonic or video meetings
b) [4:299.2] Electronic meetings
(c) [4:300] Annual meeting of directors
(d) [4:301] Other regular meetings
1) [4:302] Whether notice of meeting required
(e) [4:303] Special meetings
1) [4:303.1] Notice required
2) [4:304] How much notice
a) [4:305] Oral notice given to another
b) [4:305.1] Notice during "emergency"
3) [4:306] Need not state purpose of special meeting
(f) [4:307] Waiver of notice of meetings
1) [4:308] By attending and failing to object
2) [4:309] Written waiver
(g) [4:310] Action without meeting by directors' unanimous written consent
1) [4:310.1] Consent where "interested" or "common" director abstains
a) [4:310.2] Action valid despite deficient disclosures
(h) Quorum requirements for board meetings
1) [4:311] Statutory standard
2) [4:314] Bylaws should not increase required quorum
3) [4:315] Bylaws may reduce quorum to one-third of authorized directors
4) [4:315.1] Officer deemed director during "emergency"
5) [4:316] Loss of quorum at meeting
a) [4:317] Example

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b) [4:318] Prohibiting director action where quorum lost
(i) Required vote for director action
1) [4:320] Statutory standard
2) [4:323] Provisions for less-than-majority vote invalid
3) [4:324] Provision for higher voting requirement
a) [4:324.1] Compare
(j) [4:325] Adjournment of meetings
1) [4:326] Required notice of adjournment
(10) [4:327] Restricting power of directors to adopt or amend bylaws
c. Bylaws relating to officers
(1) [4:328] Statutory standards
(a) [4:329] Officers required
(b) [4:330] Holding multiple offices
(c) [4:331] How officers chosen
(2) [4:332] Variations permitted in the bylaws (or articles) relating to officers
(a) [4:333] Designating additional officers
(b) [4:334] Designating corporate treasurer
(c) [4:335] Fixing and describing officers' duties
(d) [4:336] Designating other than president or chairperson of board as chief executive officer
(e) [4:337] Limiting the number of offices that may be held by one person
(f) [4:338] Providing that officers may be appointed by persons other than board of directors
(g) [4:339] Establishing fixed term of office
1) [4:340] Compare—contractual right to office
(h) [4:341] Limiting authority of officers to bind corporation
1) [4:342] Statutes protecting third parties dealing with corporation
2) [4:345] Effect of bylaws purporting to limit officers' authority
d. [4:346] Bylaws relating to indemnification of corporate agents
e. [4:352] Bylaw relating to share certificates
(1) [4:353] Statutory standards re issuance of share certificates
(a) [4:354] Share issuance by electronic means
(b) [4:355] Facsimile signatures of corporate officers
1) [4:355.1] Comment
(c) [4:356] Validity of signatures
(2) [4:357] Legend or statement required on share certificate
(a) [4:358] Partly-paid shares
(b) [4:359] Class rights, preferences, privileges
(c) [4:360] Transfer, other restrictions
(d) [4:361] Certificates of statutory close corporation
(e) [4:361.1] Certificates of SPCs
(f) [4:361.2] Certificates of benefit corporations
(3) [4:362] Procedure for replacing lost, stolen or destroyed certificates
f. [4:363] Bylaw limiting corporate distributions
(1) [4:364] Comment
g. [4:365] Bylaws relating to corporate records and reports
(1) [4:366] Shareholders list
(a) [4:367] Directors' right to inspect shareholder list
(b) [4:368] Shareholders' right to inspect shareholder list
1) [4:369] Right absolute for 5% shareholders
a) [4:370] Procedure

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b) [4:371] Effect of failure to furnish list
2) [4:372] Qualified right for less than 5% shareholders
a) [4:373] Comment
3) [4:374] Bylaws may expand inspection rights
a) [4:375] Comment
(2) [4:376] Inspection of bylaws
(3) Inspection of other corporate records
(a) [4:378] By directors
(b) [4:379] By shareholders
1) [4:380.1] Access to records in California
2) [4:381] Common law inspection rights
3) [4:382] Bylaws may expand statutory rights
a) [4:383] Comment
4) [4:383.1] Internal affairs doctrine
a) [4:383.2] Caution—subject to internal affairs doctrine in Delaware
(4) [4:384] Annual report to shareholders
(a) [4:385] Statutory requirements
1) [4:386] Contents
a) [4:387] Additional disclosures required where 100 or more shareholders
b) [4:388] Accounting standards
(b) [4:389] When bylaws may dispense with annual report
(c) [4:391] Shareholders' right to financial statements where no annual report furnished
(d) [4:393] Enforcement of shareholders' right to annual report
(e) [4:393.5] Annual benefit report (benefit corporations)
(5) [4:394] Annual information statement filed with Secretary of State
h. [4:397] Bylaws relating to "emergency"
(1) [4:397.1] "Emergency" defined
(2) [4:397.2] Specific provisions
(3) [4:397.3] Limitation where shareholder approval required
(4) [4:397.4] No liability for "good faith" acts
i. [4:397.11] Bylaws relating to shareholder disputes
(1) [4:397.12] Provision selecting litigation forum
(a) [4:397.12a] Comment
(2) [4:397.13] Provision shifting attorney fees
(3) [4:397.14] Mandatory arbitration of disputes

1. [4:171] **Bylaws Generally Not Required by Law:** Except in the one instance noted below (¶ *4:172*), there is no legal requirement that a corporation adopt bylaws. The adoption of bylaws is strictly optional, because the matters normally covered in bylaws are already covered in the Corporations Code. Nonetheless, as a practical matter, bylaws are adopted by virtually every corporation (*see* ¶ *4:173 ff.*).

a. [4:172] **Exception where number of directors not stated in articles:** There is one situation in which bylaws are required by statute to complete the organization of the corporation: If the number of directors is not specified in the articles of incorporation, bylaws *must* be adopted specifying the number of directors for the corporation. [Corps.C. § 212(a)]

(Moreover, those bylaws must be adopted *prior to the first meeting* of the board of directors, since they establish the number of directors authorized at the first meeting; *see* ¶ *4:399*.)

2. [4:173] **Purposes of Bylaws:** Although, as stated, bylaws are not generally required as a matter of law, most corporations have bylaws. This is because they serve a number of useful functions:

a. [4:174] **To provide "housekeeping" rules:** Corporate bylaws are the regulations and rules established by the corporation for its own governance and that of its shareholders, directors and officers. Bylaws typically set forth the "housekeeping"

rules and procedures governing the internal conduct of the corporate affairs: e.g., officers' functions, dates and places of shareholders' and directors' meetings, etc. [Corps.C. § 212(b)]

b. [4:175] **To recite statutory standards:** It is customary for the bylaws to restate a great number of the statutory rules, procedures, and standards relating to corporate governance. While this may be redundant, it is useful because it provides in one convenient place all of the rules applicable to meetings of directors and shareholders, and management of the corporation and its affairs. This serves as a handy reference for corporate officers and other personnel who may not have ready access to the statutory provisions themselves.

c. [4:176] **To vary statutory standards:** Many of the statutory standards can be varied in the articles or bylaws (*see ¶ 4:51*). Thus, if the organizers desire a different rule or procedure than provided by the Code, and the statutory standard is one that can be varied in the bylaws, an appropriate bylaw provision can be adopted to accomplish the desired result.

3. Procedural Considerations

a. [4:177] **Adoption, amendment and repeal of bylaws:** Bylaws may be adopted, amended or repealed either by:

• All of the incorporators prior to the election of directors; or

• A majority of the outstanding voting shares; or

• Action of the board of directors (subject to limitations noted *at ¶ 4:180 ff.*). [Corps.C. §§ 210, 211, 212(a)]

(1) [4:178] **By incorporators before election of initial directors:** If the initial directors have not been named in the articles, the incorporator or incorporators may adopt and amend bylaws of the corporation until the first directors are elected. [Corps.C. § 210]

(a) [4:179] **Required where directors not named in articles:** Indeed, where the initial directors are not named, nor the number of directors designated in the articles, the incorporators would *have* to adopt bylaws which initially establish the authorized number of directors for the corporation; *see ¶ 4:172*.

(2) [4:180] **By board of directors:** Bylaws may also be adopted, amended or repealed, by action of the board of directors —subject, however, to certain important limitations:

(a) [4:181] **Articles or bylaws may restrict board's power:** The articles or previously-adopted bylaws may restrict or eliminate the power of the board to adopt, amend, or repeal any or all of the bylaws. [Corps.C. § 211]

(b) [4:182] **Restriction on change in number of directors:** Ordinarily, bylaws can be changed either by the directors or shareholders (*¶ 4:184*).

However, once shares have been issued, only the *shareholders* can change the authorized number of directors. Thus, where the bylaws fix the number of directors, any amendment to such provision after shares have been issued must be adopted or approved by a majority of the outstanding voting shares. [Corps.C. § 212(a)]

(c) [4:183] **Restriction on filling vacancies on board resulting from removal of directors:** Vacancies on the board of directors caused by removal of one or more directors during their term of office may be filled *only by the shareholders* (by either majority vote at a meeting or unanimous written consent of the outstanding voting shares) *unless* the articles or bylaws confer upon the remaining directors the power to fill such vacancies. But any such *bylaw* is valid only if adopted by the shareholders; i.e., the *board itself cannot adopt* a bylaw granting it the power to fill such vacancies. [Corps.C. § 305(a); *see ¶ 4:87*]

(3) [4:184] **By shareholders:** Bylaws may be adopted, amended or repealed at any time by approval of a majority of the outstanding voting shares. [Corps.C. §§ 211, 212]

b. [4:185] **Maintaining bylaws:** Every corporation must keep the original or a copy of its bylaws, as amended to date, at its principal office in California, or, if it has no principal office here, at its principal *business* office in California. [Corps.C. § 213]

c. [4:186] **Shareholders' right to inspect bylaws:** The shareholders have an absolute right to inspect the bylaws at all reasonable times during regular office hours at the corporation's principal office in California, or if none, at its principal *business* office in California. If the corporation has neither a principal office nor a principal business office in California, it must furnish a copy of its bylaws, as amended to date, to any shareholder making a written request for same. [Corps.C. § 213; *see ¶ 4:377*]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

4. Drafting Considerations—In General

a. [4:187] **Whether to adopt or vary statutory standards:** As stated above, one of the principal purposes of bylaws is to collect in one convenient place the statutory rules governing the conduct of meetings of directors and shareholders and other formalities for conducting the corporation's business (¶ 4:174).

A few of these statutory standards are mandatory, so that contrary provisions in the bylaws are prohibited (*see ¶ 4:189 ff.*). However, most of the statutory provisions can be varied by the organizers if they so desire. Therefore, before drafting the bylaws, counsel should review the statutory standards with the organizers, and decide whether it is desirable to draft bylaws changing these standards (assuming the change is permissible as a matter of law).

• ***FORM:*** Bylaws, *see Form 4:B*.

b. [4:188] **Caution re using "model" bylaws:** Be careful about using form bylaws supplied in corporate kits (*see ¶ 4:170*). The sample or "model" bylaws often supplied with such kits may, or may not, accurately recite the current statutory standards. If they do not, the provisions may create problems. And, even if they do, they may not be what the organizers would desire if given a choice. Counsel can usually do a much better job for the organizers by counseling them as to the available alternatives, and then tailoring bylaw provisions to fit their needs.

c. [4:189] **Certain bylaws PROHIBITED:** The Code provides that the bylaws may include any provision for the regulation and management of corporate affairs that is "not inconsistent with law or with the articles of incorporation." [Corps.C. § 212(b)]

➪ [4:190] ***PRACTICE POINTER:*** It is your responsibility to review each proposed bylaw to make sure that it is not in conflict with any provision of the articles of incorporation. It is also your responsibility to make sure that the bylaws are not inconsistent with *current* statutory standards. (This is one of the reasons that form bylaws supplied in corporate kits should be used with caution; *see ¶ 4:188.*)

(1) [4:191] **Bylaws prohibited by statute:** Certain statutory standards relating to quorum and voting requirements at directors' and shareholders' meetings cannot be varied either in the articles or bylaws. These have already been discussed in connection with the articles (*see* ¶ *4:91 ff., 4:137 ff.*), and apply with equal effect here.

Other statutory standards that may not be varied in the articles or bylaws include:

• Statutory provisions for appointment of a provisional director. [Corps.C. § 308(a) (*¶ 8:845 ff.*)]

• Statutory restrictions on a corporation's power to indemnify its officers and directors. [Corps.C. §§ 204(a)(11), 317(g) (¶ *4:145.1, 6:436*); see also Corps.C. § 2603(a)(11) (SPCs, *¶ 9:43*)]

• Shareholder rights to inspect and copy corporate records and shareholders list. [Corps.C. §§ 1600(d), 1601(b) (*¶ 6:504 ff.*)]

• Certain *notice requirements* at directors' and shareholders' meetings (*see* ¶ *6:68, 6:198*).

➪ [4:192] ***PRACTICE POINTER:*** Bylaws originally valid may be prohibited by later changes in federal or state law. Therefore, if you continue to represent the corporation after formation, *review the bylaws periodically.* It is usually your responsibility to determine if amendments are required to conform to changes in the law.

(2) [4:193] **Matters reserved exclusively to articles:** There are also some statutory standards that may be varied, but only in the articles of incorporation and *not in the bylaws* (*see ¶ 4:55*). As to such matters, while a contrary provision in the articles would be valid, a contrary provision in the bylaws is void and ineffective. [See Corps.C. § 204(a); see also Corps.C. § 2603(a) (SPCs)]

(3) [4:194] **Bylaws conflicting with articles:** A bylaw provision is also invalid if it conflicts with any provision of the articles of incorporation. [Corps.C. § 212(b); *Morris v. Richard Clark Missionary Baptist Church* (1947) 78 CA2d 490, 492-493, 177 P2d 811, 813]

(4) [4:195] **Bylaws inherently unfair or unreasonable:** Finally, a bylaw provision may be held invalid if it is inherently unfair, arbitrary, or unreasonable in its application. [See *People's Home Sav. Bank v. Sup.Ct.* (1894) 104 C 649, 652, 38

P 452, 452-453—invalidating bylaw limiting persons to whom proxies could be granted; *Ferry v. San Diego Museum of Art* (1986) 180 CA3d 35, 41-46, 225 CR 258, 261-265 (nonprofit corporations have duty to follow fair and reasonable procedures re members); *Braude v. Automobile Club of Southern Calif.* (1978) 78 CA3d 178, 184, 144 CR 169, 172 (fair and reasonable election procedures are fundamental to proper governance of nonprofit corporations)]

5. [4:196] **Particular Bylaw Provisions:** The following is a summary of (and commentary on) particular matters that may be considered for inclusion in the corporation's bylaws. While by no means exhaustive, it can be used as a "checklist" of possible alternatives to discuss with the organizers in preparing the corporation's bylaws.

[4:197] ***Reserved.***

a. Bylaws governing shareholders' meetings and action

(1) [4:198] **Place of shareholders' meetings:** The bylaws may specify where shareholder meetings are to be held, either inside or outside California. Or, alternatively, the bylaws may provide the manner in which the meeting place is to be determined (e.g., authorizing the directors to select the site). If the bylaws fail to do either, the Code provides that shareholder meetings are to be held at the corporation's principal offices. [Corps.C. § 600(a)]

➪ [4:199] ***PRACTICE POINTER:*** It is generally best to avoid specifying the place for shareholder meetings. For greater flexibility, the bylaws should give the directors authority to select the place. This enables the directors to change the meeting place, if necessary, from time to time, and avoids the trouble and expense of having to amend the bylaws just to change the site for shareholder meetings. This may become particularly important if a public emergency (earthquake, flood, terrorist act, etc.; *see ¶ 4:397 ff.*) renders the selected meeting place temporarily inaccessible.

However, if the organizers are concerned about future boards scheduling shareholders' meetings at inconvenient times and places, the place of meetings can be specified in the bylaws.

[4:199.1 - 4:199.4] ***Reserved.***

(2) [4:199.5] **Virtual shareholder meeting requirements:** A meeting of the shareholders may be conducted, in whole or in part, by "electronic transmission by and to the corporation," electronic video screen communication, conference telephone, or "other means of remote communication." [Corps.C. § 600(e) (amended Stats. 2023, Ch. 115; eff. 1/1/24); *see* ¶ 4:199.8 ff. (permissible means of electronic communication)]

If a corporation conducts a virtual shareholder meeting (entirely or partially), it must implement reasonable measures:

- to provide shareholders (in person or by proxy) a reasonable opportunity to participate in the meeting (including the capability to read or hear the proceedings in real time as they occur) and to vote on matters submitted to the shareholders;

- to record any vote or action taken by a shareholder or proxyholder via electronic, telephonic, or other "remote" means; and

- to verify that each person who has voted remotely is a shareholder or proxyholder. [Corps.C. § 600(e)]

(a) [4:199.6] **Requirements for virtual meetings:** An *entirely virtual* shareholder meeting may be held only if *one or more* of the following apply:

- All shareholders give their unrevoked consent; *or*

- The board determines that a virtual meeting is necessary or appropriate because of an emergency (¶ 4:397.1); *or*

- Notwithstanding the absence of shareholder consent, the meeting is conducted on or before December 31, 2025, and includes a live audiovisual feed for the duration of the meeting. In this circumstance, in addition to providing an audiovisual feed, the corporation may offer an audio-only feed provided the choice of which feed to use is made by the shareholder and the corporation does not impose any barriers to either means of participation. A *de minimis*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

disruption of the feed does not require the corporation to end the meeting or render the corporation out of compliance with the remote meeting requirements. [Corps.C. § 600(e) (amended Stats. 2023, Ch. 115; eff. 1/1/24)]

[4:199.7] ***Reserved.***

(b) [4:199.8] **"Electronic transmission by and to the corporation" defined:** An "electronic transmission by and to the corporation" means a communication that is delivered by (i) fax or email to a predesignated fax number or email address, (ii) posting on a predesignated electronic message board or network, or (iii) any "other means of electronic communication." [Corps.C. §§ 20, 21]

The electronic transmission must create a record that can be retained, retrieved, reviewed, and rendered "into clearly legible tangible form." [Corps.C. §§ 20, 21]

1) [4:199.9] **Consent and notice requirements for electronic transmissions *by corporations:*** Recipients must consent to receiving a corporation's communication under or pursuant to the Corporations Code via electronic transmission (¶ 4:199.8). [Corps.C. § 20]

If a corporation posts a communication on an electronic message board or network, it must separately notify the recipient of the posting. The communication is validly delivered when both the communication is posted and the separate notice is delivered, whichever is later. [Corps.C. § 20]

a) [4:199.10] **Disclosure required for electronic transmissions to individual shareholders:** There are additional disclosure requirements if the corporation is sending an electronic transmission (¶ 4:199.8 ff.) to an individual shareholder or a corporate member who is a natural person. Prior to or simultaneously with the recipient's consent to receive an electronic transmission (¶ 4:199.9), the corporation must provide "a clear written statement" that discloses: (i) any right to receive the record on paper or in nonelectronic form; (ii) whether the consent applies only to that transmission, specified categories of communications, or to all communications from the corporation; and (iii) the procedures for withdrawing the recipient's consent. [Corps.C. § 20]

If the recipient is an officer or director, these additional requirements only apply if the communication is sent to that person in their capacity as a shareholder or member. [Corps.C. § 20]

2) [4:199.11] **Compare—electronic transmissions *to corporations:*** To receive electronic communications from shareholders, members or directors, a corporation must have in place "reasonable measures" to verify the sender's identity. [Corps.C. § 21]

(3) [4:200] **Date of annual meeting of shareholders:** An annual shareholders' meeting is required for the election of directors. In addition to such election, any other proper business may be transacted at the annual meeting. [Corps.C. § 600(b); *see* ¶ *6:13*]

The bylaws may specify the exact date, time and place such annual shareholders' meeting will be held; or, alternatively, the bylaws may authorize the directors to fix such date, time and place. [Corps.C. § 600(b)]

➪ [4:201] ***PRACTICE POINTER:*** Ordinarily, the annual meeting should be held no earlier than 60 to 120 days after the end of the corporation's fiscal year. This allows sufficient time for the corporation to prepare financial statements for the past year and provide them to the shareholders for their consideration at the annual meeting.

Again, for maximum flexibility, it is best *not* to fix an exact time for these meeting in the bylaws. Rather, the bylaws should authorize the directors to schedule the meeting within these time limits.

(a) [4:202] **Remedy for failure to hold annual meeting:** See Corps.C. § 600(c), *discussed at* ¶ *6:56*.

(4) Special meetings of shareholders

(a) [4:203] **Who may call special meetings:** The Code provides that special meetings of the shareholders may be called by the board of directors, by the chairperson of the board, by the president of the corporation, or by shareholders having at least 10% of the voting shares. The bylaws may specify *additional* persons entitled to call a special meeting of shareholders. [Corps.C. § 600(d); *see* ¶ *6:58*]

➪ [4:204] ***PRACTICE POINTER:*** In closely-held corporations, it may be desirable for the bylaws to allow others to call a special shareholders' meeting: e.g., *any* officer, or the holders of a specified percentage of voting shares representing *less* than 10% of the voting power.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) [4:205] **Procedures for calling special shareholders' meetings:** Although not required, it is customary for the bylaws to specify the procedures to be followed in calling a special shareholders' meeting by anyone entitled to do so.

1) [4:206] **Written request, specifying general nature of business to be transacted:** If a special meeting is called by any person other than the board of directors, the bylaws typically provide that the request for the meeting must be in writing, specifying the date, time and place of such meeting and the *general nature of the business* proposed to be transacted (which is required in the notice of meeting; *see ¶ 6:74*).

2) [4:207] **Delivery of request to corporation:** The bylaws also usually require that such written request be delivered personally, or sent by registered or certified mail, to the chairperson of the board, or the president, or the secretary of the corporation.

(c) [4:208] **Obligation of corporation to comply with request for special meeting:** Where a special shareholders' meeting is requested by persons other than the board of directors, the corporate officer receiving such request must comply therewith and cause notice of the meeting to be given to the shareholders. The notice must be given within 20 days after receipt of the request, and the meeting must be actually held not less than 35 days nor more than 60 days after receipt of such request. [Corps.C. § 601(c); *see ¶ 6:62*]

1) [4:209] **Remedy for failure to comply:** See Corps.C. § 601(c), *discussed at ¶ 6:64 ff.*

2) [4:210] **Access to mailing list of shareholders:** If the persons requesting such a meeting propose to give notice of the meeting themselves, they will need access to a current list of the shareholders' names and addresses. For discussion of the shareholders' right to examine the records of the corporation, and to obtain the shareholders list, see Corps.C. § 1600(a), *¶ 6:522 ff.*

(5) [4:211] **Notice of shareholders meeting:** The Corporations Code sets forth the notice and other requirements for both annual and special shareholders' meetings. [See Corps.C. § 601, *¶ 6:68*]

(a) [4:212] **How much notice required:** For any shareholders' meeting (annual or special), written notice of the meeting must be given *not less than 10 and not more than 60 days* before such meeting. (Exception: In corporations having 500 or more shareholders of record, the notice may be sent by third-class mail, see below (¶ 4:213); in which event, it must be mailed not less than 30 days before the meeting.) [Corps.C. § 601(a); *see ¶ 6:82*]

(b) [4:213] **Manner of giving notice:** If a corporation has less than 500 shareholders of record as of the record date for the meeting, the meeting notice must be given either in person, by electronic transmission (e.g., fax or email, *see* ¶ 4:199.8 ff., 4:216.1 ff.) or by first-class mail. [Corps.C. § 601(b)(1)]

If a corporation has 500 or more shareholders of record as of the record date for the meeting, the meeting notice may be sent by third-class mail or any other means of written communication. [Corps.C. § 601(b)(1)]

1) [4:214] **Address problems:** The notice must be addressed to the shareholder at the address (e.g., street address, email address, or fax number) that appears in the corporation's books or the shareholder provided to the corporation. [Corps.C. § 601(b)(1)]

If there is no address in the corporate records and the shareholder did not give one, then the notice may be (i) addressed to the shareholder at the corporation's principal office, or (ii) published at least once in a newspaper of general circulation in the county where the principal office is located. [Corps.C. § 601(b)(1)]

If any properly addressed notice or report is returned to the corporation by the U.S. Postal Service and marked to indicate that it cannot be delivered to the shareholder at the address provided, the corporation does not have to send future notices or reports to the shareholder as long as the notices and reports are available to the shareholder upon written demand at the corporation's principal office for one year. [Corps.C. § 601(b)(2)]

a) [4:215] **Comment:** The alternative of mailing the notice to shareholders at the corporation's principal office is of doubtful efficacy. Although authorized by statute, it should be avoided in the bylaws.

2) [4:216] **Time notice deemed given:** Notice is deemed given when delivered personally, sent by fax or electronic transmission (in accordance with Corps.C. § 20, ¶ 4:199.8 ff.), or deposited in the mail or sent by other means of written communication. An affidavit of mailing, electronic transmission, electronic communication or other means of remote communication of such notice, executed by the corporate secretary (or any assistant secretary or the corporate transfer agent) is prima facie evidence of the giving of the notice. [Corps.C. § 601(b)(1); *see ¶ 6:80*]

3) [4:216.1] **Electronic notices:** Notices sent by electronic transmission must comply with Corps.C. § 20 (¶ 4:199.8 ff.). [Corps.C. § 601(b)(3)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [4:216.2] **Notices during emergency:** A corporation may send a shareholder meeting notice or any report electronically (¶ 4:199.8 ff.) if the board determines that it is necessary or appropriate because of an emergency (¶ 4:397.1). [Corps.C. § 601(b)(1)]

b) [4:216.3] **Inability to send electronically:** Unless there is an emergency (¶ 4:397.1), a corporation cannot send a meeting notice to a shareholder electronically if (i) the corporation was unable to deliver two consecutive notices by electronic means, or (ii) the corporation's secretary, assistant secretary, transfer agent, or any other person responsible for giving the notice knows that the corporation is unable to deliver the notice electronically. [Corps.C. § 601(b)(3)]

(c) Content of notice

1) [4:217] **Time, date, place:** Notice of a shareholders' meeting (whether annual or special) must of course state the place, date and hour of such meeting. [Corps.C. § 601(a)]

2) [4:217.1] **Virtual or remote participation:** If applicable, the notice must also specify the means of electronic transmission by and to the corporation, electronic video screen communication, conference telephone, or other means of remote communication by which shareholders may participate in the meeting. [Corps.C. § 601(a); *see* ¶ 4:199.5 ff.]

3) [4:218] **Management nominees for election as directors:** Notice of a meeting at which directors are to be elected (which must be at least at each annual meeting of shareholders) is required to include the names of nominees intended at the time of the notice to be presented by the board for election as directors. [Corps.C. § 601(a)]

4) [4:219] **Business to be transacted—annual meetings:** For an *annual* meeting, the notice must state whatever matters the board, at the time of giving the notice, intends to present for action by the shareholders. [Corps.C. § 601(a)]

[4:220] Even so, matters *not* so specified may be presented to the meeting and considered and acted upon by the shareholders … subject to the following limitation: If the general nature of any of the following matters has not been stated in the notice, approval is required by *all shareholders entitled to vote*, unless they sign *waivers* of notice (*see ¶ 4:225*):

- Approval of a transaction in which a director has a financial interest, under Corps.C. § 310;
- Approval of an amendment to the articles of incorporation under Corps.C. § 902;
- Approval of a conversion under Corps.C. § 1152;
- Approval of a reorganization under Corps.C. § 1201;
- Approval of a voluntary dissolution under Corps.C. § 1900; or
- Approval of a liquidating distribution inconsistent with preferred share preferences under Corps.C. § 2007. [Corps.C. § 601(f); *see ¶ 6:73*]

5) [4:221] **Business to be transacted—special meetings:** In the case of special meetings of shareholders, the notice *must* state the "general nature" of the business to be transacted. *No other business* than that specified may be transacted at the special meeting *unless all shareholders* entitled to vote sign *waivers* (*¶ 4:225 ff.*). [Corps.C. § 601(a), (e); *see ¶ 6:74*]

a) [4:222] **Comment:** Adequacy of notice is a fertile area for dispute. Shareholders often attack actions taken at shareholders' meetings on the ground that the notice was defective.

FORMS

- Notice of Annual Meeting of Shareholders, *see Form 6:C*.
- Notice of Special Meeting of Shareholders, *see Form 6:D*.

(d) [4:223] **Waiver of notice:** Any deficiency in the notice of a shareholders' meeting can be waived.

1) [4:224] **By attending meeting *without objecting:*** Shareholders who attend a meeting—in person or by proxy—are deemed to waive notice of such meeting unless they object at the *commencement* of the meeting to the transaction

of any business because the meeting is not lawfully called or convened; or expressly object during the meeting to consideration of *particular matters* that were required to be, but were not, included in the meeting notice. [Corps.C. § 601(e); *see* ¶ *6:85*]

2) [4:225] **By written waiver before or after meeting:** As long as a quorum is present at the shareholders' meeting, the transactions are as valid as though the meeting was duly noticed if all shareholders entitled to vote who are not present (in person or by proxy) provide a written waiver of notice or a consent to the holding of the meeting, or an approval of the minutes thereof, *either before or after the meeting*. All such waivers, consents or approvals must be filed with the corporate records. [Corps.C. § 601(e); *see* ¶ *6:86*]

- ***FORM:*** Waiver of Notice and Consent to Holding of (Annual/Special) Meeting of Shareholders, *see Form 6:E.*

a) [4:226] **Waiver need not disclose matters to be acted upon:** Unless the articles or bylaws provide otherwise, such waiver or consent *need not specify* either the business to be transacted or the purpose of any annual or special meeting. [Corps.C. § 601(e)]

b) [4:227] **Exceptions:** The rule is contrary where the action taken or proposed to be taken relates to any of those five matters specified in ¶ *4:220*—i.e., directors' conflict of interest, amendment of articles, conversion, reorganization, voluntary dissolution, or liquidating distribution conflicting with preferred share preferences. In these cases, the general nature of the matter so approved *must be stated in the waiver* of notice. [See Corps.C. § 601(e), (f)]

(6) [4:228] **Shareholder action *without meeting by written consent:*** In general, shareholder action may be taken *without* a meeting, and without prior notice, by written consents provided by shareholders having enough votes to take such action at a shareholders' meeting. [Corps.C. § 603(a)]

(a) [4:229] ***Caution—unanimity ordinarily required for election of directors by written consent:*** Although directors may be elected by *majority* vote at a shareholders' meeting, an election by written consent requires the consent of *all* shares entitled to vote for the election of directors … *except* for an election to fill a vacancy created by a director's death or resignation, which the shareholders may fill by written consent of a *majority* of the outstanding voting shares. (An election by written consent to fill a vacancy created by *removal* requires unanimity.) [Corps.C. § 603(d); *see* ¶ *6:158*]

(b) [4:230] **Bylaws may not restrict right:** The *articles* may eliminate or restrict the shareholders' right to take action by written consent in lieu of a meeting (*see* ¶ *4:127*). However, apparently the bylaws may not eliminate or restrict this right. [See Corps.C. § 603(a)]

[4:230.1 - 4:230.4] ***Reserved.***

(c) [4:230.5] **Electronic consent permitted:** The written consent may be given by facsimile, telegraphic or other electronic transmission (e.g., email). [Corps.C. §§ 603(a), 195]

(d) [4:231] **Notice required to nonconsenting shareholders:** Where shareholder action has been taken by written consent without a meeting, "prompt notice" must be given to all shareholders who have not provided such consent (unless their consents had previously been solicited in writing). [Corps.C. § 603(b)(2); *see* ¶ *6:166*]

1) [4:232] **Matters requiring notice *before action taken:*** Moreover, such notice to nonconsenting shareholders must be given *at least 10 days before consummation* of the following transactions (to give the nonconsenting shareholders opportunity to take action to prevent consummation):

- Approving "interested director" transactions (Corps.C. § 310, ¶ *6:286*);

- Granting indemnification to a corporate agent (Corps.C. § 317, ¶ *6:436; but see* ¶ *4:232.1* re SPCs);

- Declaring a liquidating distribution inconsistent with preferred share preferences (Corps.C. § 2007, ¶ *8:947*);

- Approving conversions (Corps.C. § 1152, ¶ *8:451; but see* ¶ *4:232.1* re SPCs), other than conversions in which dissenters' rights apply (Corps.C. § 1300 et seq., ¶ *8:292 ff., 8:473*);

- Approving reorganizations (Corps.C. § 1201, ¶ *8:173; but see* ¶ *4:232.1* re SPCs), other than reorganizations in which dissenters' rights apply (Corps.C. § 1300 et seq., ¶ 8:292 ff.). [Corps.C. § 603(b)(1)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [4:232.1] **Application to SPCs?** In the situation of *SPC* conversions, reorganizations and indemnification, it is not clear whether the requisite 10-day notice must be given to nonconsenting shareholders. Corps.C. § 603(b)(1) refers specifically to Corps.C. §§ 1201, 1152 and 317, and this poses a problem:

• SPC conversions are governed not by Corps.C. § 1152 but, rather, by its SPC counterpart, Corps.C. § 3302.

• Similarly, SPC reorganizations are governed not by Corps.C. § 1201 but, rather, by its SPC counterpart, Corps.C. § 3401.

• Lastly, indemnification by an SPC is governed by Corps.C. § 2702, and questions exist regarding the applicability of Corps.C. § 317 to SPCs (*see* *¶ 9:121 ff.*).

It is possible that these situations would be governed by the "prompt" notice requirements applicable to "any other corporate action" (Corps.C. § 603(b)(2), ¶ 4:231). However, it would be prudent to give the 10-day notice to nonconsenting SPC shareholders in all these situations.

(e) [4:233] **Revoking written consent:** Shareholder consents are revocable only by a writing delivered to the corporation *before* it has received sufficient consents from other shareholders to authorize the proposed action; and not thereafter. [Corps.C. § 603(c); *see* *¶ 6:165*]

(f) [4:234] **Special form of consent required where at least 100 shareholders of record:** If there are 100 or more shareholders of record (and the corporation is *not* subject to the reporting requirements of the Securities Exchange Act of 1934), any form of written consent (or proxy) distributed to 10 or more shareholders must include the *choice* between approval and disapproval of each matter intended to be acted upon, other than elections of directors or officers. [See Corps.C. § 604(a), *¶ 6:162*]

(7) [4:235] **Record date for shareholder notice or action:** A "record date" is required so that the corporation may determine the shareholders entitled to notice of any meeting, or to vote thereat. (It is also required to determine those to whom dividends or other distributions are to be paid by the corporation; *see* *¶ 7:86*.)

The Code establishes the following procedures for fixing the "record date." These procedures may be varied in the articles (Corps.C. § 701(d)), and apparently also in the bylaws (see Corps.C. § 212(b)(7)).

(a) [4:236] **Board authorized to fix record date:** The board of directors may fix a record date in advance of a shareholders' meeting or other corporate action. The date so fixed must not be fewer than 10 days nor more than 60 days before the date of the shareholders' meeting (or in the case of any other proposed corporate action, not more than 60 days prior to any such other action). [Corps.C. § 701(a)]

(b) [4:237] **Where no record date fixed by board:** If no record date is fixed by the board, then:

1) [4:238] **For shareholders' meeting:** The record date for giving notice of, and entitlement to vote at, shareholders' meetings is the close of business on the day preceding the day on which notice is given; or, if notice is waived, the record date is the business day before the day the meeting is held. [Corps.C. § 701(b)(1); *see* *¶ 6:90*]

This applies also to *adjourned* meetings unless the board fixes a new record date for such adjourned meeting. (The board is required to fix a new record date where a meeting is adjourned for more than 45 days from the date of the original meeting; *see* *¶ 6:92*.) [Corps.C. § 701(c)]

2) [4:239] **For action by shareholder consents:** The record date for determining shareholders entitled to give written consent to corporate action without a meeting (where no prior action by the board has been taken) is the day on which the first written consent is given by any shareholder. [Corps.C. § 701(b)(2); *see* *¶ 6:160*]

3) [4:240] **For any other purpose:** The record date for any other purpose, including matters previously acted upon by the board of directors, is the close of business on the day the board adopts a resolution relating to such matter, or the 60th day prior to the date of such action, whichever is later. [Corps.C. § 701(b)(3); *see* *¶ 6:94*]

(8) [4:241] **Quorum for shareholders' meetings:** The bylaws typically restate the statutory requirement that a majority of the outstanding shares entitled to vote must be represented (either in person or by proxy) to constitute a quorum at a shareholders' meeting. [Corps.C. § 602(a); *see* *¶ 6:116*]

(a) [4:242] **Bylaws may not vary statutory standard:** The statutory quorum requirement *cannot* be varied at all in the *bylaws*. [See Corps.C. § 602(a)—"Unless otherwise provided in the *articles*"]

Compare: Nor may the articles *increase* the quorum required for shareholder meetings (except in statutory close corporations, *see ¶ 4:113*). However, the articles may *reduce* the quorum required to as little as *one-third* of the outstanding shares; see Corps.C. § 602(a), *¶ 4:110*.

➪ [4:243] ***PRACTICE POINTER:*** If the articles do reduce the statutory quorum requirement, make sure the bylaws are drafted to conform to the articles provision. (Again, this is a problem with using "standard form" bylaws that merely restate the statutory standards.)

[4:243.1 - 4:243.4] ***Reserved.***

(b) [4:243.5] **Shareholders present by electronic means:** Shareholders not physically present (in person or by proxy) at a meeting may, by electronic transmission by and to the corporation, electronic video screen communication, conference telephone, or other means of remote communication (¶ 4:199.5 ff.), be deemed present (in person or by proxy) for the purpose of establishing a quorum. [Corps.C. § 600(a), (e); *see ¶ 4:265.1*]

(c) [4:244] **Where no quorum at outset:** If less than the required number of shares to constitute a quorum is present (either in person or by proxy) at the commencement of the meeting, such meeting may be *adjourned* from time to time by the vote of a majority of the shares represented; but no other business may be transacted. [Corps.C. § 602(c); *see ¶ 6:119*]

1) [4:245] **When notice of adjournment required:** Unless the articles or bylaws provide otherwise, notice of an adjourned shareholders' meeting is *not* required if the time and place thereof (or the means of electronic transmission by and to the corporation, electronic video screen communication, conference telephone, or other means of remote communication, if any, by which the shareholders may participate) are announced at the meeting, *unless:*

• The adjournment is for more than 45 days; *or*

• After such adjournment, the board fixes a new record date for such adjourned meeting.
In such cases, notice must be given to each shareholder of record entitled to vote at such adjourned meeting. [Corps.C. § 601(d); *see ¶ 6:120*]

(d) [4:246] **Loss of quorum at meeting:** Although there may have been a quorum at the outset, if enough shareholders withdraw from the meeting, the remaining shareholders may be powerless to act. Any action other than adjournment must be approved by a *majority* of the shares required to constitute the quorum originally (or by the vote of a *greater* percentage, or of a majority (or greater percentage) of each *class*, if so required by the articles or other Code provisions). [Corps.C. § 602(b); *see ¶ 6:121*]

1) [4:247] **Examples:** If there are 1,000 outstanding shares entitled to vote at the shareholders' meeting, a statutory quorum is 501.

• If the holders of 200 shares withdraw from the meeting, any further action (other than adjournment) that may be taken by a simple *majority* requires approval of 251 of the remaining 301 shares represented at the meeting.

• If an action requires a *supermajority* vote (e.g., two-thirds) at a duly-convened meeting, the requisite supermajority of the original quorum (e.g., 334 shares) would be required for approval of the action, but where 200 shares withdraw from the meeting, only 301 shares remain so the action could not be approved.

• If an action requires approval by a majority (or greater percentage) of each *class* of shares, the calculation of the number required for approval must be made separately for each class.

(9) [4:248] **Proxies:** By statute, shareholders have the right to vote their shares in person or to execute proxies authorizing another person to vote their shares at a shareholders' meeting. [Corps.C. § 705(a)]

(a) [4:249] **Statutory right cannot be eliminated:** The bylaws may vary the "manner of execution, revocation, and use of proxies," but neither the bylaws nor the articles may eliminate the statutory right to vote by proxy. [See Corps.C. §§ 212(b)(3), 705(a)]

(b) [4:250] **Form of proxy:** A "proxy" is an authorization by a shareholder (or the shareholder's appointee under a valid power of attorney) giving another one or more persons the power to vote with respect to such shareholder's shares. The authorization may be made in writing, by electronic transmission or orally by telephone. [See Corps.C. § 178]

1) [4:250.1] **Telephone proxies:** If given by telephone, the proxy *must* be submitted with information indicating the proxy was authorized by the shareholder (or the shareholder's attorney-in-fact). [Corps.C. § 178]

2) [4:250.2] **Written/electronic proxies:** If given in writing or by electronic transmission, the proxy need *not* be signed manually by the shareholder; it is sufficient if the shareholder (or the shareholder's attorney-in-fact) places the shareholder's name or other authorization on the proxy, whether by manual signature, typewriting, telegraphic or electronic transmission, or otherwise. [Corps.C. § 178; *¶ 6:105*]

(c) [4:251] **Presumption favoring validity of proxies:** Any proxy purporting to be executed in accordance with the Corporations Code is presumptively valid. [Corps.C. § 705(a)]

(d) [4:252] **Duration of proxy:** If no term is stated in the proxy, it expires automatically at the end of 11 months from date of execution. The parties may specify a longer term in the proxy itself, in which event it may continue for whatever term is so specified (no limit). [Corps.C. § 705(b); *see ¶ 6:109*]

(e) [4:253] **Revocability of proxies:** However, regardless of any stated duration, the person executing the proxy has the *power to revoke* it—unless the proxy has become irrevocable, as discussed below (¶ 4:256 ff.). [Corps.C. § 705(b)]

1) [4:254] **Revocation by maker of proxy:** The shareholder who executed the proxy can revoke it (unless it has become irrevocable, *see ¶ 4:256*) either by:

• A *writing* delivered to the corporation stating that the proxy is revoked; or

• Subsequently executing a *new proxy*; or

• *Attending the meeting* for which the proxy was given and voting their shares personally. [Corps.C. § 705(b); *see ¶ 6:110*]

2) [4:255] **Revocation upon death, incapacity of maker:** A proxy remains valid until the corporation receives *written notice* of the death or incapacity of the maker. Thus, shareholder actions taken before such written notice is received are not affected. [Corps.C. § 705(c); *see ¶ 6:111*]

3) [4:256] **When irrevocable:** A proxy that *expressly states* it is irrevocable for a specified period, will be held irrevocable for the period specified, if executed in favor of any of the following (so long as they retain their status as such):

• A *pledgee* of the shares;

• Persons holding an *option or contract to purchase* the shares, or who have sold any portion of their shares to the maker of the proxy;

• *Creditors* of the corporation or of the shareholder who extended or continued such credit in consideration of being given the proxy (provided it specifically so states and sets forth the name of the person extending or continuing such credit);

• Persons who have contracted to perform services as an *employee* of the corporation where such employment contract provided for the giving of a proxy (provided it specifically so states and sets forth the name of the employee and the period of employment contracted for);

• Persons *designated by a shareholders' voting agreement* (including a voting trustee under a voting trust) pursuant to Corps.C. § 706 (*see ¶ 3:159.5 ff.*);

• *Beneficiaries of a trust* holding shares of the corporation;

• Persons to whom the proxy was given to *secure the performance of any duty or to protect a title*, either legal or equitable, until the happening of events which, by the terms of such proxy, discharge the obligations secured by it. [See Corps.C. § 705(e); *¶ 6:112*]

4) [4:257] **"Irrevocable" proxy may be revoked by transfer of shares:** Although a proxy is otherwise irrevocable, it may be revoked by a transferee of the shares with respect to which the proxy was given, if such transferee took

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

without knowledge of the existence of the irrevocable nature of the proxy, and the existence of the proxy and its irrevocability *do not appear on the share* certificate. [Corps.C. § 705(f); *see* ¶ *6:114*]

➪ [4:258] ***PRACTICE POINTER:*** Obviously, if you represent the person to whom an irrevocable proxy is given, you should attempt on behalf of your client either to obtain the share certificate itself (i.e., as pledgee), or to have a *legend imprinted upon the certificate* stating that an irrevocable proxy has been granted (e.g., given as security for repayment of loan, pursuant to employment contract, etc.).

(f) [4:259] **Special proxy form required for corporations with at least 100 shareholders:** Where proxies are solicited from 10 or more shareholders of any corporation having 100 or more shareholders of record (and not subject to the reporting requirements of the Securities Exchange Act of 1934), the proxy form must afford the person solicited an opportunity to *specify a choice between approval or disapproval* of each matter or group of matters intended to be acted upon at the meeting for which the proxy is solicited. [Corps.C. § 604(a); *see* ¶ *6:106*]

[4:260] Further, where proxies are solicited in connection with the election of directors, the proxy form should state the names of the director-candidates and afford the person solicited opportunity to indicate approval, disapproval, or the opportunity to withhold their vote for any such candidates. [Corps.C. § 604(b); *see* ¶ *6:107*]

(g) [4:261] **Federal proxy solicitation rules:** Proxy solicitation is also regulated by federal law if the corporation is a 1934 Act reporting company (i.e., the corporation's shares are traded on a national securities exchange, or the corporation has total assets exceeding $10 million and either (i) 2,000 or more record shareholders or (ii) (if the corporation is not a bank or bank holding company) 500 or more record shareholders who are not “accredited” investors (¶ *5:174 ff.*)). [SEA §§ 12(g), 14; SEC Rule 14(a)]

FORMS

• Proxy for Use with Corporations Having Fewer than 100 Shareholders, *see Form 6:F*.

• Proxy for Use with Corporations Having 100 or More Shareholders, *see Form 6:G*.

(10) [4:262] **Shareholder voting procedures:** The statutory rules governing shareholder voting rights and procedures may be varied somewhat in the articles of incorporation (*see* ¶ *4:114*). But the statutory standards are *not* variable at all in the *bylaws.*

The statutory standards (usually recited in the bylaws) are as follows:

(a) [4:263] **Voting rights per share:** Each share outstanding, regardless of class, is entitled to one vote on each matter submitted to a vote of shareholders, *unless the articles provide otherwise*. [Corps.C. § 700(a); *see* ¶ *6:96*]

Special *cumulative voting rules* apply to the election of directors (*see* ¶ *6:134*). However, a “listed” corporation can eliminate cumulative voting for directors simply by amending its articles *or bylaws* to so provide. [Corps.C. § 301.5; *see* ¶ *4:88.13 ff.*]

➪ [4:264] ***PRACTICE POINTER:*** If the articles do provide otherwise, make sure the bylaws are drafted consistently. Again, “standard form” bylaws may create problems where the articles vary the statutory standard.

(b) [4:265] **Voting only part of shares:** A shareholder may vote part of their shares and refrain from voting the balance. But to do so, the shareholder must clearly *specify* the number of shares being voted; otherwise, there is a *conclusive* presumption that they are voting all shares entitled to vote. [Corps.C. § 700(b); *see* ¶ *6:133*]

(c) [4:265.1] **Voting by video or electronic means:** Shareholders not physically present in person or by proxy at a meeting may, by electronic transmission by and to the corporation, electronic video screen communication, conference telephone, or other means of remote communication (¶ 4:199.5 ff.), be deemed present in person or by proxy, and may participate and vote at the meeting. [Corps.C. § 600(a), (e); *see* ¶ *4:199.5 ff.*]

(d) [4:266] **Required vote for shareholder action:** Unless otherwise provided in the articles, the affirmative vote of a majority of the shares represented at a meeting at which a quorum is present constitutes valid shareholder action. [Corps.C. § 602(a); *see* ¶ *6:123*]

1) [4:267] **When supermajority vote required:** The articles may require a *greater* (but not lesser) percentage of votes for any shareholder action (*see* ¶ *4:114*).

[4:268] In addition, the Code itself requires a greater-than-majority shareholder approval for certain important corporate transactions. For example, approval by a majority (or in some instances, *two-thirds*) of the *outstanding* shares (rather than the shares present at a meeting at which a quorum is present) is required for:

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- *Amendment* of the articles. [Corps.C. §§ 902, 903 (¶ *8:57 ff.*); see also Corps.C. §§ 3000, 3001 (SPCs, ¶ *9:261 ff.*); Corps.C. §§ 14603, 14604, 14610 (benefit corporations, ¶ *9:533, 9:641, 9:663*)]

- Sale of all or substantially all of the corporate assets. [Corps.C. § 1001 (¶ *8:589*); see also Corps.C. § 3100 (SPCs, ¶ *9:302*); Corps.C. § 14603 (benefit corporations, ¶ *9:651*)]

- Conversions. [Corps.C. § 1152 (¶ *8:471*); see also Corps.C. §§ 3001, 3301 (SPCs, ¶ *9:272, 9:322*); Corps.C. § 14603 (benefit corporations, ¶ *9:536, 9:666*)]

- Share exchange tender offers or mergers or other reorganizations. [Corps.C. §§ 1201, 1201.5 (¶ *8:173*); see also Corps.C. §§ 3201, 3401 (SPCs, ¶ *9:313*); Corps.C. § 14603 (benefit corporations, ¶ *9:536*)]

(e) [4:269] **Voting by fiduciaries, etc.:** Corps.C. §§ 702-704 set forth in considerable detail who may vote shares held by fiduciaries (e.g., administrators, executors, guardians, conservators, or custodians), shares in the name of a receiver, shares subject to pledge or standing in the name of a minor, or in the name of another corporation or held in the names of two or more persons (*see* ¶ 6:98 ff.).

1) [4:270] **Comment:** These statutory provisions may be restated in the bylaws if desired. However, it is not customary to do so, because voting by fiduciaries is rarely encountered in corporations that are not publicly-traded.

(f) [4:271] **Voting pursuant to shareholder agreement:** Shareholders may enter into a written agreement as to how their voting rights shall be exercised and may establish whatever voting procedures they choose. [Corps.C. § 706(a); *see* ¶ *3:159.1*]

(11) [4:272] **Election inspectors:** The directors, in their discretion, may appoint election inspectors to act at a shareholders' meeting. Moreover, upon the request of *any* shareholder, the chair of the shareholders' meeting *must* appoint election inspectors for the meeting. [Corps.C. § 707(a); ¶ *6:149*]

(a) [4:273] **Number of inspectors:** Either one or three inspectors shall be appointed. If appointed at the request of shareholders, the majority of shares present at the meeting decides whether one or three inspectors are to be appointed. [Corps.C. § 707(a)]

When three are appointed, the decision of the majority controls. [Corps.C. § 707(c)]

(b) [4:274] **Function of election inspectors:** The election inspectors determine the number of shares outstanding, their voting rights, the number of shares represented at the meeting, the existence of a quorum, and the authenticity, validity, and effect of any proxies presented at the meeting.

The inspectors also receive all votes, ballots, or written consents, hear and determine all challenges and questions arising in connection with the right to vote, and count and tabulate all votes or consents. They determine when voting is terminated, the result of such voting, and do such other acts as may be proper to conduct the election or vote with fairness to all shareholders. [Corps.C. § 707(b); *see* ¶ *6:150*]

(c) [4:275] **Good faith requirement:** The Code requires the inspectors to perform their duties impartially, in good faith, to the best of their ability and as expeditiously as is practical. [Corps.C. § 707(c); *see* ¶ *6:152*]

b. Bylaw provisions relating to directors

(1) [4:276] **Fixing number of directors (*required where articles silent):*** The only bylaw *required* by statute is one fixing the authorized number of directors if the articles fail to do so. In such case, the bylaws must designate either a fixed number, or a variable number within a stated minimum and maximum. [Corps.C. § 212(a)]

Cross-refer: The same rules and limitations apply as to provisions in the articles of incorporation fixing the number of directors: i.e., at least three directors required (except before shares are issued or where there are less than three shareholders); provisions for fixed vs. "flexible" board; provisions for "staggered" terms ("listed" corporations only), etc. (*see* ¶ 4:70 ff.).

[4:277] ***Reserved.***

(2) [4:278] **Special qualifications for directors:** The bylaws may optionally establish special qualifications for directors. (For example, a provision requiring that, to be eligible to be elected and serve as a director, a person own beneficially a specified minimum number of shares of the corporation.) [See Corps.C. § 212(b)(4); ¶ *4:78*]

(a) [4:278.1] **"Independence" requirements for directors of "listed" corporations:** The listing standards of the New York Stock Exchange, NYSE American, Nasdaq Global Select Market, Nasdaq Global Market and Nasdaq Capital Market require that a majority of the corporation's directors be "independent," as defined in the standards (e.g., generally, the director and their family members must have no current or recent material relationship with the company). Special independence requirements also apply to audit, nominating and compensation/corporate governance committee members. [See NYSE Listed Company Manual §§ 303A.01-303A.02, 303A.04-303A.07; NYSE American Company Guide §§ 802-805; Nasdaq Rule 5605(b)]

The bylaws of listed corporations (or corporations contemplating listing) may contain a provision mirroring, or mandating compliance with, the applicable independence requirements.

(b) [4:278.2] **Female director requirements for "listed" corporations:** As of January 1, 2020, every publicly held corporation (domestic or foreign) that has its principal executive offices in California (according to its SEC Form 10-K) must have at least one female director. As of January 1, 2022, such corporations must have more than one female director if the corporations have five or more directors (*see* ¶ 4:278.2c). [Corps.C. §§ 301.3(a), (b), 2115.5 (Corps.C. § 301.3 applies to foreign corporation "to the exclusion of the law of the jurisdiction in which the foreign corporation is incorporated")]

1) [4:278.2a] **"Publicly held" defined:** "Publicly held" refers to a "corporation with outstanding shares listed on a major United States stock exchange." [Corps.C. §§ 301.3(f)(2), 2115.5(b); for designated national securities exchanges, see Corps.C. § 25101(a); Commr.Rule 260.101.2; Commr.Rel. Nos. 87-C (revised 2009), 88-C (revised 2009)]

The same definition applies to the requirement for a minimum number of directors from an underrepresented community (¶ 4:278.3 ff.). [Corps.C. §§ 301.4(e)(2), 2115.6(b)]

2) [4:278.2b] **"Female" director defined:** The statute defines "female" as "an individual who self-identifies her gender as a woman, without regard to the individual's designated sex at birth." [Corps.C. § 301.3(f)(1)]

3) [4:278.2c] **Minimum number of female directors after 2021:** The minimum number of female directors that must be on the board of a publicly held corporation in California by December 31, 2021, will be based on the total number of directors the corporation has:

• If the corporation has four directors or less, at least *one* must be female;

• If the corporation has *five* directors, at least *two* must be female;

• If the corporation has *six or more* directors, at least *three* must be female. [Corps.C. § 301.3(b)]

A corporation may increase the number of directors to comply with these requirements. [Corps.C. § 301.3(a)]

4) [4:278.2d] **Regulations; potential fines for noncompliance:** The Secretary of State may adopt regulations to implement the foregoing provisions (¶ 4:278.2 ff.). The Secretary of State may also impose the following fines for violations:

• $100,000 for failure to timely file board member information with the Secretary of State; and

• $100,000 for a first violation and $300,000 for subsequent violations of the director requirements. [Corps.C. § 301.3(e)(1)]

a) [4:278.2e] **"Violation" defined:** Each director seat that must be held by a female but that is *not* held by a female for at least a portion of a calendar year counts as a violation. [Corps.C. § 301.3(e)(2); see also Corps.C. § 301.3(e)(3) ("a female director having held a seat for at least a portion of the year shall not be a violation")]

5) [4:278.2f] **Pending constitutional challenges:** There are several pending federal and state lawsuits challenging the constitutionality of Corps.C. § 301.3. As of publication, no appellate court has ruled on the statute's ultimate constitutionality. [See *Meland v. Weber* (9th Cir. 2021) 2 F4th 838, 847—shareholder of publicly traded company headquartered in California has standing to bring action challenging Corps.C. § 301.3's constitutionality; *Meland v.*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Weber (ED CA 2021) 2021 WL 6118651, *1, *8 (unpub.opn.) (collecting ongoing lawsuits and denying preliminary injunction because Corps.C. § 301.3 "is substantially related to its remedial goal and likely to survive a facial challenge"); *and* ¶ 4:278.3f (constitutional challenges to statute requiring minimum number of directors from underrepresented communities)]

An unpublished state trial court decision found the gender quota requirement violated the equal protection clause of the California constitution (see *Crest v. Padilla* (Sup.Ct. 2022) 2022 WL 1565613, *12 (unpub.opn.)). As of publication, that decision was pending on appeal. [See *Padilla v. Crest,* No. B322276]

(c) [4:278.3] **Directors from underrepresented communities; requirements for "listed" corporations:** In addition to a minimum number of female directors (¶ 4:278.2 ff.), publicly held corporations (domestic or foreign) with principal executive offices in California (according to their SEC Form 10-Ks) must also have a minimum number of directors from underrepresented communities on their boards by December 31, 2021 (¶ 4:278.3c). [Corps.C. §§ 301.4, 2115.6 (Corps.C. § 301.3 applies to foreign corporation "to the exclusion of the law of the jurisdiction in which the foreign corporation is incorporated")]

Based on the statutory text, a female director who is also from an underrepresented community would count towards both director mandate requirements under Corps.C. §§ 301.3 (¶ 4:278.2) and 301.4.

1) [4:278.3a] **"Publicly held" defined:** *See* ¶ 4:278.2a.

2) [4:278.3b] **"Director from an underrepresented community" defined:** A "director from an underrepresented community" refers to "an individual who self-identifies as Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self-identifies as gay, lesbian, bisexual, or transgender." [Corps.C. § 301.4(e)(1)]

3) [4:278.3c] **Minimum number of directors from underrepresented communities:** As of January 1, 2022, every publicly held corporation (domestic or foreign) that has its principal executive offices in California (according to its SEC Form 10-K) must have at least one director from an underrepresented community on its board. [Corps.C. §§ 301.4(a), 2115.6(a)]

By the end of 2022, the minimum number of directors from underrepresented communities increases for corporations that have five or more directors. [Corps.C. § 301.4(b)] Specifically:

- If a corporation has four or fewer directors, the corporation must have at least one director from an underrepresented community;

- If a corporation has more than four but fewer than nine directors, the corporation must have at least two directors from underrepresented communities; and

- If a corporation has nine or more directors, the corporation must have at least three directors from underrepresented communities. [Corps.C. § 301.4(b)]

4) [4:278.3d] **Regulations; potential fines for noncompliance:** The same potential fines for noncompliance that the Secretary of State may adopt for violating the female director requirements (¶ 4:278.2d ff.) may also be adopted for violating the requirement for a minimum number of directors from underrepresented communities:

- $100,000 for failing to timely file board member information with the Secretary of State; and

- $100,000 for the first violation, and $300,000 for subsequent violations. [Corps.C. § 301.4(d)]

a) [4:278.3e] **"Violation" defined:** Each director seat that must be held by a director from an underrepresented community but that is *not* held by a director from an underrepresented community for at least a portion of a calendar year counts as a violation. [Corps.C. § 301.4(d)(2)(A); see also Corps.C. § 301.4(d)(2)(B) ("a director from an underrepresented community having held a seat for at least a portion of the year shall not be a violation")]

5) [4:278.3f] **Pending constitutional challenges:** A state trial court determined that Corps.C. § 301.4 violates the California Constitution's Equal Protection Clause because the statute "treats similarly situated individuals—qualified potential corporate board members—differently based on their membership (or lack thereof) in certain listed racial, sexual orientation, and gender identity groups." The court concluded that the plaintiffs were entitled to an injunction

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

preventing the Secretary of State from enforcing Corps.C. § 301.4. [*Crest v. Padilla* (Sup.Ct. 2022) 2022 WL 1073294, *19-20] As of publication, that decision was pending on appeal. [See *Crest v. Padilla,* No. B321726]

In a similar lawsuit challenging both Corps.C. §§ 301.3 and 301.4 under the U.S. Constitution's Equal Protection Clause, a federal district court found AB 979 facially unconstitutional under the Equal Protection Clause of the Fourteenth Amendment and declined to sever the legislation to exclude the groups whose inclusion violated equal protection. [See *Alliance for Fair Bd. Recruitment v. Weber* (CD CA 2023) 2023 WL 3481146, *2, appeal filed 6/16/23 (Case No. 23-25901); *and* ¶ 4:278.2f (constitutional challenges to statute requiring minimum number of female directors)]

(3) [4:279] **Duties and compensation:** The bylaws may also fix the compensation to be paid to directors for their services in such capacity, and may contain an enumeration of specific duties. [Corps.C. § 212(b)(4)]

(4) [4:280] **Powers of directors:** Bylaws typically restate the broad powers conferred on directors by the Code re management of the corporation's affairs: i.e., subject only to any limitations imposed by its articles, and statutory requirements that certain acts be approved by the shareholders (¶ 6:12), “the business and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.” [Corps.C. § 300(a)]

(a) [4:281] **Exception in case of statutory close corporation:** The board of directors may be bypassed in a statutory close corporation. The shareholders of such a corporation may, pursuant to their agreement, directly manage its affairs. [Corps.C. § 300(b); *see* ¶ *3:248*]

(b) [4:282] **Board may delegate management:** The board may delegate the management of day-to-day operation of the corporation's business to a management company or other person, *provided* that such management and the exercise of corporate powers is at all times under the ultimate direction of the board. [Corps.C. § 300(a); *see* ¶ *6:179*]

(c) [4:283] **Board committees:** Except as to specifically enumerated matters (¶ *4:285*), the board of directors may delegate any of its powers to one or more committees of the board, each consisting of two or more directors. Such committees serve at the pleasure of the board. [Corps.C. § 311; *see* ¶ *6:181*]

1) [4:284] **How committees established:** Committees may be established and their members appointed by resolution adopted by the majority of the *authorized number of directors* (not just merely a majority of those present at the meeting). [Corps.C. § 311; *see* ¶ *6:185*]

2) [4:285] **Powers delegable to committees:** A committee so appointed has all of the powers and authority of the board itself, *except* as otherwise provided in the bylaws or in the resolution appointing the committee … and subject to the further exception that the following specific powers are *not delegable* by the board:

• Approval of any action requiring shareholder approval. [Corps.C. § 311(a)]

• Filling board vacancies or vacancies on any committee of the board. [Corps.C. § 311(b)]

• Fixing compensation of directors for service on the board or any committee. [Corps.C. § 311(c)]

• Adopting, amending or repealing bylaws. [Corps.C. § 311(d)]

• Amending or repealing any board resolution which by its express terms is not amendable or repealable. [Corps.C. § 311(e)]

• Declaring a dividend or other distribution to the shareholders (but a committee may be delegated the power to declare dividends or distributions at a rate, in a periodic amount, or within a price range set forth in the articles or determined by the board). [Corps.C. § 311(f)]

• Appointing other committees of the board or members thereof. [Corps.C. § 311(g)]

3) [4:286] **Requirements and procedures for committee meetings:** All of the statutory provisions dealing with the notice, quorum, voting and other procedures for board meetings and action of directors apply also to board committees. [Corps.C. § 307(c); *see* ¶ 4:296 ff.]

4) [4:286.1] **Requirements imposed on “*listed” corporations:*** Corporations having shares listed on the New York Stock Exchange, NYSE American, Nasdaq Global Select Market, Nasdaq Global Market or Nasdaq Capital Market

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

must comply with applicable listing standards requiring the establishment of certain board committees (e.g., audit, nominating/corporate governance, compensation) and setting forth membership qualifications (e.g., independence). [See NYSE Listed Company Manual §§ 303A.04-303A.07; NYSE American Company Guide § 803; Nasdaq Rule 5605(c)-(e)]

It is recommended that these requirements be stated in the bylaws. (*See* ¶ *4:278.1*.)

(5) [4:287] **Time of annual election of directors:** The bylaws may also establish the time of the directors' annual election. [Corps.C. § 212(b)(4)]

Typically, the bylaws provide that directors shall be elected in conjunction with and at each annual shareholders' meeting, and shall hold office until the next annual shareholders' meeting and until their successors are elected and qualified (unless sooner removed from office, as discussed at ¶ *4:288*).

"*Listed*" corporations may, by amendment to their *bylaws* (or articles), divide the board into two or three classes to serve for staggered terms of two or three years respectively. Even here, however, a minimum of three directors must be elected at each annual shareholders' meeting (for further discussion, *see* ¶ *4:77a ff.*). [Corps.C. § 301.5]

[4:287.1 - 4:287.5] ***Reserved.***

(6) [4:287.6] **Staggered terms (mutual water companies):** A mutual water company may adopt a bylaw (or article) provision electing directors to serve staggered four-year terms. [Corps.C. § 301.9; *see* ¶ *3:148.3*]

(7) [4:288] **Removal of directors from office:** The bylaws often restate the statutory provision authorizing the board to declare vacant the office of a director convicted of a felony or declared incompetent by court order. [Corps.C. § 302; *see* ¶ *6:238*]

[4:289] In addition, the shareholders may remove one or more directors *without cause* if such removal is *approved by a majority of the outstanding shares* entitled to vote for the election of directors—provided, however, that no individual director may be removed over the objection of a number of shares sufficient to elect such director under cumulative voting. This is so *even* in the case of "listed" corporations that have eliminated cumulative voting and established a "classified" board. [Corps.C. § 303(a)(1)-(3), (c); *see* ¶ *6:20 ff.*]

[4:290] Directors may also be removed *for cause* by *court order*. Such order may be granted upon the petition of shareholders holding at least 10% of the outstanding shares of any class, and only on grounds of fraudulent or dishonest acts or gross abuse of authority. [Corps.C. § 304; *see* ¶ *6:239*]

(8) [4:291] **Filling vacancies on the board of directors:** A vacancy exists when there are fewer directors holding office than authorized. Such vacancy may result from death, resignation, removal, increase in the authorized number of directors, or otherwise. [Corps.C. § 192]

However, a director's failure to attend meetings does *not* by itself create a vacancy (other than as the result of death, resignation, or the above (¶ *4:288 ff.*) specified removal procedures)—i.e., the absent and nonparticipating director must be carried on the board until their term expires.

(a) [4:292] **Filling vacancies due to death or resignation:** Vacancies arising due to the death, incapacity or resignation of any director may be filled upon approval of the remaining directors, unless the bylaws (or articles) provide otherwise. [Corps.C. § 305(a); *see* ¶ *4:86*]

(b) [4:293] **Vacancies due to removal of director:** Vacancies caused by removal of a director may be filled *only by the shareholders*—by either a majority vote at a duly convened meeting or *unanimous written consent*—*unless* the articles or a bylaw adopted by the shareholders (not the directors alone) authorizes the remaining directors to fill the vacancy. [Corps.C. §§ 305(a), 603(d); *see* ¶ *4:87*]

(c) [4:294] **Shareholders may fill other vacancies not filled by directors:** The shareholders may elect a director at any time to fill a vacancy on the board not filled by the directors. The shareholders may act either at a meeting or by written consent of a *majority* of the outstanding shares entitled to vote (*except* where the vacancy results from removal of a director, in which event an action by written consent must be *unanimous*; *see* ¶ *4:293*). [Corps.C. §§ 305(b), 603(d)]

(d) [4:295] **Right of shareholders to elect entire board where majority of directors have not been elected by shareholders:** A special procedure is available where a *majority* of the directors have been appointed, rather than elected, to office (e.g., as the result of earlier vacancies and board appointments to fill such vacancies): Holders of 5% or more of the outstanding shares may call a special meeting of shareholders for the purpose of electing an entire new board of

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

directors. If the meeting is not promptly held, such shareholders may apply to the Superior Court for a summary order calling a special shareholders' meeting for such purpose. [See Corps.C. § 305(c)]

(9) [4:296] **Matters relating to board meeting:** The Code sets forth various rules relating to regular and special meetings of the board of directors, and the procedures therefor. [Corps.C. § 307; *see ¶ 6:188 ff.*]

These statutory standards are set forth below (¶ 4:297 ff.), and are often simply adopted intact in the bylaws. However, except with respect to the voting quorum requirements (*¶ 4:311 ff.*) and voting requirements (*¶ 4:320 ff.*), these statutory standards *can* be altered or augmented in the bylaws (or articles).

(a) [4:297] **How meetings are called:** Regular or special meetings of the board may be called by the chair of the board, or the president, or any vice-president, or the secretary, or any two directors. [Corps.C. § 307(a)(1); *see ¶ 6:193*]

Regular meetings may be held without a specific call for such meeting, if the time and place of such meetings are fixed in the bylaws, or have been fixed by prior resolution of the board of directors. [Corps.C. § 307(a)(2); *see ¶ 6:189*]

(b) [4:298] **Place of meetings:** Meetings of the board of directors may be held anywhere designated in the notice of the meeting; or, if not stated in the notice (or if there is no notice), at such place designated in the bylaws, or by resolution of the board. [Corps.C. § 307(a)(5); *see ¶ 6:207*]

Typically, bylaws provide that, in the absence of other designation of the place for either a regular or special meeting of the board, such meetings shall be held at the principal office of the corporation.

1) [4:299] **Board meeting by telephone, electronic or video conference:** Directors need not convene and be physically present together in the same room at a meeting. A board meeting may be held by conference telephone, electronic video screen communication or other electronic transmission by and to the corporation. [Corps.C. § 307(a)(6)]

a) [4:299.1] **Telephonic or video meetings:** Participation in a meeting through conference telephone or video screen communication constitutes "presence in person" so long as all participating members are able to hear each other. [Corps.C. § 307(a)(6)]

b) [4:299.2] **Electronic meetings:** Participation in a meeting through use of electronic transmission by and to the corporation (¶ 4:199.8 ff.) constitutes "presence in person" provided both of the following conditions are satisfied:

- Each participating director can communicate with all of the others concurrently; and
- Each director is given the means to participate in all matters before the board, including the capacity to propose or object to a specific action to be taken by the corporation. [Corps.C. § 307(a)(6); *see ¶ 6:210b*]

(c) [4:300] **Annual meeting of directors:** While the shareholders are required by law to meet at least annually for the election of directors (Corps.C. § 600(b), *¶ 6:13*), there is *no* specific requirement for an annual meeting of the board of directors.

However, such an annual meeting is customary, and ordinarily is held immediately following each annual shareholders' meeting. Accordingly, bylaws typically provide that the board of directors shall hold an organizational meeting immediately following each annual meeting of the shareholders (to appoint officers, etc.).

(d) [4:301] **Other regular meetings:** It is also customary, but not required, for the bylaws to fix the dates, times and places for the holding of other regular meetings of the board of directors; e.g., quarterly or monthly.

But, again, this is not essential. Where it is difficult to determine in advance when board meetings should be held, the bylaws may simply provide for monthly, quarterly or other regular meetings of the board *without* fixing the date, time or place. The effect is to give the board complete discretion as to the scheduling of its "regular" meetings. [Corps.C. § 307(a)(2)]

1) [4:302] **Whether notice of meeting required:** If the dates and place for regular board meetings *are* specified in the bylaws, or fixed by resolution of the board itself, notice of such meetings is not required. (If not so fixed, notice would have to be given to any director not present when the next meeting was scheduled.) [Corps.C. § 307(a)(5)]

(e) [4:303] **Special meetings:** In addition to regularly scheduled meetings, special meetings of the board may be called and held at any time, subject to the notice requirements below (¶ 4:303.1 ff.). [Corps.C. § 307(a)(2)]

1) [4:303.1] **Notice required:** While regular board meetings are usually held without notice (*see ¶ 4:302*), special meetings can only be held after notice to the directors (unless such notice is waived; *see ¶ 4:307 ff.*). [Corps.C. § 307(a)(2); *see ¶ 6:198*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Neither the articles nor the bylaws may dispense with the notice requirement for a special meeting (but the directors themselves can waive notice; *see ¶ 4:307 ff.*). [Corps.C. § 307(a)(2)]

2) [4:304] **How much notice:** Such notice of special meetings of the board must be mailed to the directors at least *four days* prior to the meeting; or must be given at least *48 hours* before the meeting in the case of notice given in person or by telephone (including a voice messaging system) or by fax, email or other electronic transmission by the corporation (¶ 4:199.8 ff.). [Corps.C. § 307(a)(2); *see ¶ 6:200 ff.*]

a) [4:305] **Oral notice given to another:** The requirement of oral notice in person or by telephone is satisfied even if given to someone other than the director, so long as given to a person at the office of the director who the person giving the notice has reason to believe will promptly communicate it to the director. [Corps.C. § 118; *see ¶ 6:201*]

b) [4:305.1] **Notice during "emergency":** If a public "emergency" (¶ 4:397.1) prevents notice from being given in the manner set forth in Corps.C. § 307 or the bylaws, the corporation may give notice in any practicable manner, such as by publication or radio, *unless* "emergency" bylaws (¶ 4:397 ff.) provide otherwise. Any such notice given in "good faith" during an "emergency" binds the corporation and may not be used to impose liability on a corporate director, officer, employee or agent. [Corps.C. § 207(i)(2)(A), (4)]

3) [4:306] **Need not state purpose of special meeting:** The notice of special meeting need *not* specify the purpose of the meeting. [Corps.C. § 307(a)(2); *see ¶ 6:202*]

(Compare: Notice of a special meeting of *shareholders* must set forth the matters to be acted upon at the meeting; *see ¶ 4:221*.)

(f) [4:307] **Waiver of notice of meetings:** Lack of notice or defective notice does not invalidate actions taken at a board meeting if the required quorum was present (*¶ 4:311*), and if each director who did not receive proper notice has waived such notice.

1) [4:308] **By attending and failing to object:** A director waives any defect in the notice of a meeting by attending the meeting without objecting to the lack of proper notice, prior to or at the commencement of the meeting. [Corps.C. § 307(a)(3)]

2) [4:309] **Written waiver:** A director who has not received proper notice may waive such notice, either *before or after the meeting*, by providing a written waiver of notice or consent to holding of the meeting, or an approval of minutes of the meeting. [Corps.C. § 307(a)(3); *see ¶ 6:203*]

Any such waiver, consent, or approval executed by a director not receiving proper notice must be filed with the corporate records or be made part of the minutes of the meeting. [Corps.C. § 307(a)(3)]

(g) [4:310] **Action without meeting by directors' unanimous written consent:** The board of directors may take action and conduct business without a formal board meeting if *all* members of the board, individually or collectively, consent in writing to the action and the number of then-serving directors constitutes a quorum. (But the quorum requirement does *not* apply to a written consent to fill board vacancies resulting from resignation or death; *see ¶ 4:86*.) Such written consent (or consents) must be filed with the minutes of the board's proceedings. [Corps.C. § 307(b); *see ¶ 6:233 ff.*]

(Compare: Shareholders can also take action by written consent without a meeting and, in most cases, a *majority* of the shares entitled to vote is sufficient; *see ¶ 4:228*.)

1) [4:310.1] **Consent where "interested" or "common" director abstains:** Where the action involves an "interested director" (Corps.C. § 310(a), *¶ 6:286 ff.*) or a "common director" (Corps.C. § 310(b), *¶ 6:299 ff.*) *who abstains in writing from providing consent*, action taken by the remaining directors' written consent is nonetheless deemed the unanimous consent of all directors for Corps.C. § 307(b) purposes so long as:

— the disclosures required by Corps.C. § 310 were made to the remaining directors before they executed the consent;

— the specified disclosures were "conspicuously included" in the consent executed by the remaining directors; *and*

— all the remaining directors approved the action, and their approval constitutes a sufficient "vote" without counting the interested or common directors (*see ¶ 6:296*). [Corps.C. § 307(b); *see ¶ 6:296.2a ff., 6:304.1 ff.*]

a) [4:310.2] **Action valid despite deficient disclosures:** If the disclosures did *not* comply with Corps.C. § 310, the action is nevertheless deemed approved; but in any suit brought to challenge the action, the party asserting the

validity of the action has the burden of proving the action was "just and reasonable to the corporation" at the time of approval. [Corps.C. § 307(b)]

(h) Quorum requirements for board meetings

1) [4:311] **Statutory standard:** Subject to certain variations permitted in the articles or bylaws (*¶ 4:314 ff.*), a majority of the authorized number of directors must be present to constitute a quorum of the board for the transaction of business. [Corps.C. § 307(a)(7)]

• [4:312] Directors who have a personal *financial interest* in a matter acted upon at the meeting can nevertheless be counted in determining the presence of a quorum at the meeting. [Corps.C. § 310(c); *see ¶ 6:213*]

• [4:313] On the other hand, where the meeting deals with *indemnifying* directors for litigation costs or liabilities, directors who are parties to the litigation *cannot* be counted for quorum purposes (i.e., the quorum must consist of directors who are *not* parties to such proceedings). [Corps.C. § 317(e)(1); *see ¶ 6:214*]

2) [4:314] **Bylaws should not increase required quorum:** Corps.C. § 212(b)(4) clearly permits the *bylaws* to establish "the requirements of a quorum for directors' and committee meetings." However, Corps.C. § 204(a)(5) provides that only the *articles* may set forth a quorum greater than a majority of directors. So to be safe, any provision requiring a quorum in excess of a majority of the authorized directors should be in the *articles* rather than the bylaws. [Corps.C. §§ 204(a)(5), 212(b)(4); see also Corps.C. § 2603(a)(5) (SPCs); *and ¶ 6:212*]

3) [4:315] **Bylaws may reduce quorum to one-third of authorized directors:** Either the articles or bylaws may reduce the quorum required for board action to not less than *one-third* of the authorized number of directors, or two directors, whichever is greater (except in the case of a sole-shareholder corporation, where the single director may constitute a quorum). [Corps.C. §§ 212(b)(4), 307(a)(7); *see ¶ 6:212*]

4) [4:315.1] **Officer deemed director during "emergency":** During a public "emergency" (¶ 4:397.1), the corporation may deem one or more corporate officers who are present at the meeting to be a director as may be necessary to achieve a quorum, *unless* "emergency" bylaws (¶ 4:397 ff.) provide otherwise. The designation of an officer as an "emergency" director is made in order of *rank*, and within the same rank, in order of *seniority*. (Although the Code does not expressly so state, presumably such "emergency" directors may also vote at the meeting.) Any such designation made in "good faith" during an "emergency" binds the corporation and may not be used to impose liability on a corporate director, officer, employee or agent. [Corps.C. § 207(i)(2)(B), (4)]

5) [4:316] **Loss of quorum at meeting:** If a quorum is present at the outset, the meeting may continue notwithstanding the withdrawal of one or more directors and the resulting loss of a quorum during the meeting. But any action thereafter taken must be approved by at least a majority of the initial quorum required for such meeting. [Corps.C. § 307(a)(8)]

a) [4:317] **Example:** If there are seven directors authorized, four constitutes a quorum. As long as four are present at the commencement of the meeting, the meeting can continue even though one of them walks out in the middle of the meeting. But thereafter, board action requires approval by all three remaining directors (three is a majority of the original quorum of four).

b) [4:318] **Prohibiting director action where quorum lost:** The bylaws may provide to the contrary and prohibit the continuation of a meeting whenever a quorum is lost. [Corps.C. § 212(b)(4)]

[4:319] ***Reserved.***

(i) Required vote for director action

1) [4:320] **Statutory standard:** Subject to limited variations noted below, board action may be taken by vote of a majority of the directors present at any meeting at which a quorum is established. [Corps.C. § 307(a)(8); *see ¶ 6:219*]

• [4:321] The vote of an "interested" director *cannot* be counted in authorizing, approving, or ratifying the contract or transaction between such director and the corporation. (Such director's presence at the meeting, however, does not affect the validity of the transaction; and may be counted for quorum purposes.) [Corps.C. § 310(a); *see ¶ 6:222*]

• [4:322] A director seeking *indemnification* from the corporation for litigation costs and liabilities cannot vote on the matter or be counted for quorum purposes. Indemnification can be granted only by a majority vote of a quorum of directors who are *not* parties to the litigation. [Corps.C. § 317(e); *see ¶ 6:224*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2) [4:323] **Provisions for less-than-majority vote invalid:** Neither the articles nor bylaws may authorize board action by vote of less than a majority of the directors present at a duly convened meeting. [Corps.C. § 307(a)(8)]

3) [4:324] **Provision for higher voting requirement:** The bylaws may increase the required directors' vote to a slight degree: The bylaws (as well as the articles) may require the affirmative vote of a *majority* of the *authorized* directors—rather than merely a majority of those present at a board meeting at which a quorum exists (*see ¶ 4:320*). [Corps.C. § 204(a), last paragraph; see also Corps.C. § 2603(a), last paragraph (SPCs)]

For example, in the case of a seven-member board, the bylaws could require the vote of a majority (i.e., four directors); whereas otherwise, as few as three could act, where only a bare quorum of four directors was present at the meeting.

a) [4:324.1] **Compare:** Only the articles (and *not* the bylaws) may require that board action be taken by the affirmative vote of *more than a majority* of the authorized number of directors. [Corps.C. § 204(a)(5)]

(j) [4:325] **Adjournment of meetings:** Unless provided otherwise in the articles or bylaws, a majority of directors present, whether or not constituting a quorum, may adjourn any board meeting to another time and place. [Corps.C. § 307(a)(4); *see ¶ 6:231*]

1) [4:326] **Required notice of adjournment:** Where a meeting is adjourned for *more than 24 hours*, notice of such adjournment and of the time and place to which the meeting is adjourned, must be given to the directors not present at the time of the adjournment prior to the adjourned meeting. [Corps.C. § 307(a)(4)]

(10) [4:327] **Restricting power of directors to adopt or amend bylaws:** As discussed earlier, bylaws generally can be adopted, amended or repealed *either* by the board of directors *or* shareholders. [Corps.C. § 211; *see ¶ 4:177*] (There are some statutory limitations—e.g., once shares are issued, the board cannot adopt or amend a bylaw changing the authorized number of directors without approval by a majority of the outstanding shares; Corps.C. § 212(a), *see ¶ 4:182*.)

But the articles or bylaws themselves may *restrict* or *eliminate* the board's power to adopt or amend bylaws—thereby reserving to the shareholders the exclusive authority to make any changes in the bylaws. [Corps.C. § 211]

➪ [4:327.1] ***PRACTICE POINTER:*** There are certain subjects as to which it may be a good idea to deprive the board of power to change the bylaws. For example, it may be desirable to reserve to the shareholders the sole power to make any changes in bylaw provisions fixing the scope of permissible *indemnification* for officers and directors (*see ¶ 4:346*). Likewise, the shareholders may want to prevent directors from adopting bylaws waiving the requirement of an annual report (*see ¶ 4:389*).

c. Bylaws relating to officers

(1) [4:328] **Statutory standards:** The Code sets forth various statutory standards for corporate officers, their election, terms and resignation. [See Corps.C. § 312; *see ¶ 6:262*]

These statutory standards are often restated in the bylaws:

(a) [4:329] **Officers required:** Every corporation is required to have a *president and/or chairperson of the board of directors* (who may also be given the title of *chair of the board, chairperson of the board,* or *chairperson*). Every corporation must also have a *secretary* and a *chief financial officer*. [Corps.C. § 312(a); see Corps.C. § 156.6 ("chairperson" defined)]

Unless otherwise provided in the articles or bylaws, the president (or chairperson of the board, if there is no president) is the general manager and chief executive officer of the corporation. [Corps.C. § 312(a)]

(b) [4:330] **Holding multiple offices:** Any number of offices may be held by the same individual, unless the articles or bylaws provide otherwise. [Corps.C. § 312(a)]

(c) [4:331] **How officers chosen:** Officers are appointed by the board of directors and serve at the pleasure of the board (subject, however, to any contractual employment rights). [Corps.C. § 312(b)]

The articles or bylaws may provide that officers be chosen by persons other than the board, or for a fixed term rather than at the pleasure of the board. [Corps.C. § 312(b)]

(2) [4:332] **Variations permitted in the bylaws (or articles) relating to officers:** While it is common for the bylaws simply to restate the statutory provisions above (*¶ 4:328 ff.*), the bylaws may (and often should) go beyond the statutory standards, to include provisions for officers that better fit the needs of the particular corporation. Recognizing this, the Code authorizes bylaws to state "[t]he appointment, duties, compensation, and tenure of officers." [Corps.C. § 212(b)(6)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

The following provisions are typical:

(a) [4:333] **Designating additional officers:** In addition to the officers required by statute, other corporate officers can be authorized in the bylaws, with such duties as described therein or left for determination by the board of directors.

For example, bylaws commonly provide for one or more vice-presidents, assistant secretaries, etc., to enable the corporation to sign instruments and share certificates and perform other functions customary for such offices.

(b) [4:334] **Designating corporate treasurer:** The Code no longer provides for a corporate treasurer, requiring instead that the corporation have a "chief financial officer" (Corps.C. § 312(a); *see* ¶ *4:329*).

However, an officer with the title "treasurer" is often required as a practical matter; e.g., to sign on corporate bank accounts, or financial statements.

Therefore, it is customary for the bylaws to provide that the chief financial officer shall also serve as the "treasurer" of the corporation. Alternatively, the bylaws may provide that some other officer (e.g., vice-president/finance) shall be the chief financial officer, to satisfy the statutory requirement. In this case, a separate office of treasurer may be established, subordinate to the "chief financial officer."

(c) [4:335] **Fixing and describing officers' duties:** Although the specific duties and functions of the various officers may be determined from time to time by the board of directors, it is customary for their duties and functions to be set forth in the bylaws.

(d) [4:336] **Designating other than president or chairperson of board as chief executive officer:** Although rare, the bylaws may designate someone other than the president or chairperson of the board to be general manager and chief executive officer of the corporation.

(e) [4:337] **Limiting the number of offices that may be held by one person:** Unless the bylaws provide differently, more than one corporate office can be held by the same person. [Corps.C. § 312(a); ¶ *4:330*]

However, it is frequently desirable to require that the offices of president and secretary be held by two different persons—in order that one (the corporate secretary) may attest to the signature of the other (president). An appropriate provision to this effect should be drafted for the bylaws.

(f) [4:338] **Providing that officers may be appointed by persons other than board of directors:** Although such a provision is uncommon, bylaws may authorize persons other than the board of directors to appoint the corporate officers; e.g., the president is empowered to appoint the other officers. [Corps.C. § 312(b)]

(g) [4:339] **Establishing fixed term of office:** Since officers otherwise serve at the pleasure of the board, if it is desired that any officer serve for a fixed term, such a provision should be included in the bylaws (*see* ¶ *6:266*).

There is no statutory requirement that officers be appointed or reappointed on an annual basis. If this is desired, the bylaws should so provide.

1) [4:340] **Compare—contractual right to office:** Apart from the bylaws, an officer may have a *contractual* right to a particular corporate office. (For example, a person may be hired under an employment agreement "to serve as president and general manager" of the corporation.) However, this does *not* affect the board's power to remove the person from office … subject, of course, to whatever remedies the person may have against the corporation for breach of contract. [See Corps.C. § 312(b)]

(h) [4:341] **Limiting authority of officers to bind corporation:** Limitations on the powers or authority of corporate officers are commonly found in corporate bylaws. (E.g., "No officer shall incur any indebtedness on behalf of the corporation in excess of $10,000 without approval by the board of directors.")

1) [4:342] **Statutes protecting third parties dealing with corporation:** However, such bylaw limitations generally have no effect on the rights of third parties dealing with the corporation. By statute, third parties are protected in relying on the actual or *apparent* authority of the corporate officers with whom they deal:

- [4:343] A contract or conveyance made in the name of the corporation binds the corporation if "within the scope of the authority, actual or apparent, conferred by the board or within the agency power of the officer executing it." [Corps.C. § 208(b); *see* ¶ *6:268*]
- [4:343.1] Likewise, an instrument's certificate of acknowledgment executed on a corporation's behalf by a "duly authorized person" (i.e., president, vice president, secretary, assistant secretary) is *conclusive evidence* in favor of any good faith purchaser, lessee, or encumbrancer that the instrument is the duly authorized act of the corporation. [Civ.C. § 1190]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• [4:344] Moreover, any contract, note or other evidence of indebtedness, share certificate, initial transaction statement, conveyance or other instrument, *signed* by the chairperson of the board, or president, or any vice-president *and* by the secretary or any assistant secretary, the chief financial officer or any assistant treasurer is *valid despite the signing officer's lack of actual authority* … as long as the persons receiving such instrument had no knowledge that the signing officers lacked such authority. [Corps.C. § 313; *see* ¶ *6:276*]

2) [4:345] **Effect of bylaws purporting to limit officers' authority:** Bylaws limiting the authority of corporate officers thus have little effect as far as third parties dealing with the corporation. But, such limitations *are* effective in determining the liabilities of the officers *to the corporation*: e.g., in a shareholder's derivative suit for damages to the corporation caused by dealings in excess of the authority granted by the bylaws (*see* ¶ *6:279*).

d. [4:346] **Bylaws relating to indemnification of corporate agents:** The corporation may indemnify officers, directors, employees and other persons against litigation costs and liabilities arising out of their acts on the corporation's behalf. [Corps.C. § 317, ¶ *6:436 ff.; ;* see also Corps.C. § 2702 (SPCs, ¶ *9:121 ff.*)]

[4:347] There are four available alternatives as to indemnification when drafting bylaws:

• The bylaws can be *silent* on the subject;

• The bylaws can simply *restate* the statutory provisions authorizing indemnification (which, though commonly done, has no legal effect; *see* ¶ *6:437*);

• The bylaws may *limit* the right to indemnification (e.g., allow indemnification only where the director or officer is successful on the merits of the charge, or where a court finds that the statutory standards have been met (¶ 6:463, 9:131)); or

• If authorized by the articles (¶ 4:88.8), the bylaws may provide for indemnification *greater* than permitted by Corps.C. § 317 (subject to important limitations; *see* ¶ *6:464.2*). (But it is not clear whether this alternative is available to SPCs; *see* ¶ *9:44*.)

[4:348 - 4:351] ***Reserved.***

e. [4:352] **Bylaw relating to share certificates:** The bylaws may also restate various statutory rules applicable to shares and share certificates. The following provisions are typical:

(1) [4:353] **Statutory standards re issuance of share certificates:** Every shareholder has the right to a share certificate, signed in the name of the corporation by specified officers, certifying the number of shares and class or series of shares owned by such shareholder. [Corps.C. § 416(a)]

(a) [4:354] **Share issuance by electronic means:** An exception is made where the corporation has adopted a system of share issuance by electronic or other means not involving the use of certificates. [Corps.C. § 416(b); ¶ 5:472 ff.]

(b) [4:355] **Facsimile signatures of corporate officers:** The signatures on the certificate need not be made manually. Facsimile signatures are permissible. [Corps.C. § 416(a)]

1) [4:355.1] **Comment:** Adopting a bylaw requiring manual (rather than facsimile) signatures is often desirable in a closely-held corporation. This will assure that each share certificate bears the signatures of the officers responsible for share issuance, and may avoid later controversies as to whether the shares were properly issued.

(c) [4:356] **Validity of signatures:** The holder of any share certificate may rely upon the signatures of the signing officers in the absence of actual knowledge that the signing officers had no authority to execute the certificate. [Corps.C. § 313]

(2) [4:357] **Legend or statement required on share certificate:** In certain cases, share certificates are required to bear a legend or statement as to matters affecting the shares:

(a) [4:358] **Partly-paid shares:** A certificate representing shares that are only partly paid (and therefore subject to call for the remainder of the consideration), must contain a statement as to the total amount of consideration to be paid and the amount actually paid thereon. [Corps.C. § 409(d); *see* ¶ *3:321*]

(For discussion of liability of the original subscriber and of the transferee of shares with unpaid subscription balances, see Corps.C. §§ 410-414; ¶ *3:324 ff.*)

(b) [4:359] **Class rights, preferences, privileges:** Where there are several classes of shares, or if any class of shares has two or more series, the certificate must contain an appropriate statement or summary of the rights, preferences, privileges and restrictions relating thereto, and refer to the specific provision of the articles of incorporation (or any certificate of determination) that establishes the same; *or*, it may simply designate the office of the corporation from which any shareholder may obtain, upon request without charge, a complete statement of such rights, preferences, privileges and restrictions. [See Corps.C. § 417, ¶ 5:450]

(c) [4:360] **Transfer, other restrictions:** Finally, if shares are subject to transfer restrictions, or are subject to assessment or voting agreements, or are redeemable or convertible, the certificate for such shares must set forth a statement or summary to such effect. For this requirement, and as to the consequences for noncompliance, see Corps.C. §§ 418, 2800 (SPCs), ¶ *5:451 ff.*

(d) [4:361] **Certificates of statutory close corporation:** Share certificates of a statutory close corporation must contain a prescribed statement ("conspicuous" on the face of the certificate) disclosing the close corporation status of the corporation, the maximum number of shareholders, etc. [See Corps.C. § 418(c), ¶ 5:457]

(e) [4:361.1] **Certificates of SPCs:** Share certificates of an SPC must contain a prescribed statement ("conspicuous" on the face of the certificate) disclosing that the corporation is an SPC. [Corps.C. § 2800(a), ¶ *9:61*]

(f) [4:361.2] **Certificates of benefit corporations:** Share certificates of a benefit corporation must contain a prescribed statement ("conspicuous" on the face of the certificate) disclosing that the corporation is a benefit corporation. [See Corps.C. § 14631, ¶ 9:540]

(3) [4:362] **Procedure for replacing lost, stolen or destroyed certificates:** The bylaws usually restate the statutory procedures for replacing share certificates that have been lost, stolen or destroyed: Basically, as a condition of reissuance, the corporation may require the owner or their legal representative to give a bond or other adequate security to indemnify the corporation against any claim against it on account of the alleged loss or reissuance. [Corps.C. § 419(a)]

f. [4:363] **Bylaw limiting corporate distributions:** There are a number of statutory restrictions on distributions to shareholders; e.g., adequate sources of funds, no insolvency, etc. (Corps.C. §§ 500-504; *see* ¶ *7:10 ff.*).

The bylaws (or articles) may restate or impose *additional* restrictions and limitations upon the declaration of dividends or the purchase or redemption of a corporation's own shares. [Corps.C. § 505]

(1) [4:364] **Comment:** The imposition of such additional restrictions in the articles or bylaws is rare, since they operate primarily for the benefit of corporate *creditors*, rather than shareholders. If such restrictions exist, they are usually contained in a trust indenture or other agreement with lenders or creditors, as a bargained-for protection against such corporate distributions.

g. [4:365] **Bylaws relating to corporate records and reports:** The bylaws often restate the statutory requirements for maintenance of various corporate records, and the rights of shareholders and directors to inspect such records (*see* ¶ *6:494 ff.*). These statutory rights cannot be limited, but may be expanded in the articles or bylaws (*see* ¶ *4:374*).

Shareholders also have a statutory right to receive an annual report; but the bylaws may *waive* the requirement of an annual report, under certain circumstances (*see* ¶ *6:540*).

(1) [4:366] **Shareholders list:** A record of the shareholders' names and addresses, and the number and class of shares held by each shareholder, must be maintained by the corporation at either its principal office or at the office of its transfer agent or registrar. The record must be in writing or in another form capable of being converted into clearly legible tangible form, or in a combination of the two forms. [Corps.C. § 1500]

(a) [4:367] **Directors' right to inspect shareholder list:** Corporate directors have an absolute right to inspect and copy the corporation's shareholder list, either at the corporation's offices or at the offices of the transfer agent, at any reasonable time. [Corps.C. § 1602; see *Havlicek v. Coast-to-Coast Analytical Services, Inc.* (1995) 39 CA4th 1844, 1851, 46 CR2d 696, 699; *and* ¶ *6:500 ff.*]

(b) [4:368] **Shareholders' right to inspect shareholder list:** Shareholders also have a statutory right to inspect the shareholder list. Whether the right is absolute or qualified, however, depends on the *size* of their shareholdings:

1) [4:369] **Right absolute for 5% shareholders:** Shareholders owning at least *5%* of the corporation's outstanding voting shares have the absolute and unconditional right to inspect and copy the shareholder list. (However, the ownership requirement is reduced to 1% if the corporation is required to file reports under the Securities Exchange

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Act of 1934, and the holders have filed a Schedule 14A with the SEC relating to the election of directors.) [Corps.C. § 1600(a); *see* ¶ *6:523*]

a) [4:370] **Procedure:** A shareholder so qualified is entitled to inspect *and copy* the shareholder list (either in person or by agent or attorney) upon five business days' prior written demand upon the corporation. If the records are maintained at the corporation's offices, inspection must be during usual business hours. If they are maintained by a transfer agent, the demand for inspection must be accompanied by payment for the transfer agent's usual charges for furnishing such information. [Corps.C. § 1600(a), (d)]

b) [4:371] **Effect of failure to furnish list:** If the corporation fails to comply with a qualified shareholder's demand for inspection of the shareholder list, that shareholder has the right to obtain an order from the superior court to enforce inspection. The court's order may also postpone any shareholder meeting previously noticed, and may grant any legal or equitable relief to which the shareholder may be entitled. [Corps.C. § 1600(b); *see* ¶ 6:531 ff.]

If the court finds the corporation acted "without justification" in refusing to allow inspection, the court *may* award the shareholder reasonable expenses, including attorney's fees. [Corps.C. § 1604; see *Farnum v. Iris Biotechnologies Inc.* (2022) 86 CA5th 602, 610-611, 302 CR3d 584, 590-591 (apparent case of first impression) —inspection denial is "without justification" when it is not "well grounded in both law and fact"; *and* ¶ *6:535 ff.*]

2) [4:372] **Qualified right for less than 5% shareholders:** Shareholders owning less than the required percentage of voting shares may still demand inspection of the shareholder list. However, their right to inspect and copy the list is *qualified;* i.e., they must show a "purpose reasonably related to such holder's interests as a shareholder …" [Corps.C. § 1600(c); *see* ¶ *6:524*]

a) [4:373] **Comment:** It is probably sufficient if the shareholder simply *alleges* a proper purpose for inspecting the shareholder list (e.g., to communicate with all other shareholders re corporate affairs). If the corporation refuses access to the list, the shareholder will have to seek a court order enforcing inspection rights. But the burden of proof would probably be on the corporation to show that the shareholder's purpose was improper. [See *Homestake Mining Co. v. Sup.Ct.* (1936) 11 CA2d 488, 496-497, 54 P2d 535, 538-539; see also Del.Gen.Corp.L. § 220(c), last para.—corporation has burden of proving stockholder's request to inspect stock ledger or stockholder list is for improper purpose]

3) [4:374] **Bylaws may expand inspection rights:** The above-described rights of shareholders (¶ *4:368*) to inspect the shareholders list may *not* be *limited* either by the articles or bylaws. [Corps.C. § 1600(d)]

However, the inspection rights may be *expanded* to confer an absolute right of inspection upon the holders of less than 5% of the voting stock.

a) [4:375] **Comment:** This is probably a desirable variation for corporations with relatively few shareholders. It is difficult to imagine how disclosure of the shareholders list to *any* shareholder (regardless of the amount of shares owned) could be harmful to a closely-held corporation. And, *limiting* the absolute right of inspection to holders of 5% or more of the stock may cause resentment among those holding lesser amounts (often key employees to whom small amounts of stock are issued).

However, in corporations with large numbers of shareholders, allowing one or few shareholders unrestricted access to the shareholders list could be problematic; e.g., a person could acquire shares solely for the purpose of obtaining and selling the shareholders list for commercial purposes.

(2) [4:376] **Inspection of bylaws:** The corporation's bylaws must be kept in its principal office in California, or, if its principal office is outside the state, at its principal business office here. [Corps.C. § 213; ¶ *4:185*]

[4:377] *Any* shareholder has the *absolute* right to inspect the bylaws at all reasonable times during corporate office hours. If the corporation has no principal office in California, it must furnish a copy of the bylaws to any shareholder requesting same in writing. [Corps.C. § 213; ¶ *4:186*]

(3) Inspection of other corporate records

(a) [4:378] **By directors:** Directors have an absolute right, at any reasonable time, to inspect and copy all books, records and documents of the corporation, as well as to inspect the physical properties of the corporation. [Corps.C. § 1602; see *Havlicek v. Coast-to-Coast Analytical Services, Inc.* (1995) 39 CA4th 1844, 1851, 46 CR2d 696, 699; *and* ¶ *6:500 ff.*]

(b) [4:379] **By shareholders:** The shareholders' statutory inspection rights are more limited: They are entitled to inspect the corporation's (and any subsidiary's) *books and records*, as well as the *minutes* of proceedings of the shareholders or the board of directors (or any of its committees), but only upon written demand and only "for a purpose reasonably related to the holder's interests as a shareholder…" [Corps.C. § 1601(a); *see more detailed discussion at ¶ 6:506 ff.*]

[4:380] These inspection rights may be exercised at reasonable times during the corporation's usual business hours by the shareholder in person or by their agent or attorney, and include the right to copy and make extracts from such books, records or minutes. [Corps.C. § 1601(a); *see ¶ 6:515*]

1) [4:380.1] **Access to records in California:** The corporate books, records and minutes may be inspected at the corporation's *principal office in California*. If the corporation does not have a California office, the records must be made available at the office of the corporation's *registered agent for service of process in California* (*see ¶ 4:23 ff., 3:416 ff.*). If the *original* records are not normally kept in California, or if they have been lost or destroyed, the shareholder may be given access to *copies* of the records. [Corps.C. § 1601(a)(1); *see more detailed discussion at ¶ 6:515.1*]

Alternatively, the shareholder may request the corporation to produce the books, records and/or minutes by *mail* or *electronically* so long as the shareholder pays for the reasonable costs of *copying* the documents or *converting* them to electronic format. [Corps.C. § 1601(a)(2)]

2) [4:381] **Common law inspection rights:** The Code does not allow shareholders to inspect corporate *properties*. However, California courts recognize a *common law* right to inspect *any* corporate record *or property* if a *proper and reasonable purpose* is shown. [See *Schnabel v. Sup.Ct. (Schnabel)* (1993) 5 C4th 704, 722-723, 21 CR2d 200, 211; *and ¶ 6:509.1*]

3) [4:382] **Bylaws may expand statutory rights:** Neither the articles nor bylaws may limit the statutory inspection rights granted to shareholders. [Corps.C. § 1601(b)]

But the bylaws may expand the statutory right to, e.g., include corporate properties, or make the right absolute rather than conditional on a showing of proper purpose.

a) [4:383] **Comment:** Again, such expansion of inspection rights may be desirable for small closely-held corporations. But, corporations with larger numbers of shareholders may find it burdensome.

4) [4:383.1] **Internal affairs doctrine:** In California, a shareholder's right to inspect corporate records is *not* subject to the "internal affairs" doctrine (¶ 3:4.1) and, therefore, is governed by the law of the state where a corporation operates. [*Valtz v. Penta Investment Corp.* (1983) 139 CA3d 803, 807, 188 CR 922, 924-925 (*discussed at* ¶ 6:527); *see* ¶ 6:507.1 ff.]

a) [4:383.2] **Caution—subject to internal affairs doctrine in Delaware:** In Delaware, however, shareholder inspection rights *are* considered a matter of "internal affairs" and, therefore, are governed by the law of the state of incorporation. Accordingly, a shareholder may not be able to rely on Corps.C. § 1601 to inspect books and records of a company that has its principal place of business in California, but was incorporated in Delaware. [*Juul Labs, Inc. v. Grove* (Del. Ch. 2020) 238 A3d 904, 918—stockholder of Delaware corporation with its principal place of business in California cannot seek inspection under Corps.C. § 1601 because rights governed by Delaware law; *see* ¶ 6:507.2]

(4) [4:384] **Annual report to shareholders:** By statute, an annual financial report must be sent to the corporation's shareholders. However, this requirement can be waived in the bylaws (*see ¶ 4:389*).

[4:384.1] ***Caveat re SPCs:*** The paragraphs below (¶ 4:385 ff.) describe the annual report requirements applicable to corporations organized under the General Corporation Law (Corps.C. § 100 et seq.). SPCs (which are not organized under the General Corporation Law, *¶ 9:3*) have special annual report requirements, and it is not clear whether the SPC bylaws may dispense with the annual report. *See discussion at ¶ 9:170 ff.*

(a) [4:385] **Statutory requirements:** Unless waived, an annual financial report must be provided to the shareholders at least 15 days before the annual meeting, and no later than *120 days after the close of the corporation's fiscal year*. [Corps.C. § 1501(a)(1), (2); *see ¶ 6:542*]

The corporation must deliver the report in person, by mail or by electronic transmission (¶ 4:199.8 ff.) in the same manner as a notice of shareholders' meeting (*¶ 4:213 ff.*). (But a corporation with an outstanding class of securities

registered under § 12 of the Securities Exchange Act of 1934 need only make the report available on the Internet in accordance with SEC Rule 14a-16.) [Corps.C. § 1501(a)(1), (2), (4)]

1) [4:386] **Contents:** The report must contain a balance sheet and income statement and a statement of cash flows for the fiscal year then ended. The report must also be accompanied by a report of independent accountants or be certified by an authorized officer of the corporation. [Corps.C. § 1501(a)(1); *see ¶ 6:543*]

a) [4:387] **Additional disclosures required where 100 or more shareholders:** If the corporation has 100 or more shareholders of record (and is not otherwise subject to the reporting requirements of the Securities Exchange Act of 1934), the annual report must also disclose important additional information, including:

- Any transactions involving more than $40,000 between the corporation and any of its officers, directors or more-than-10% voting shareholders (excluding officer and director compensation); and

- The amount and circumstances of any indemnification or advances for the benefit of any officer or director in excess of $10,000 which were not approved by the shareholders. [Corps.C. § 1501(b); *see ¶ 6:544*]

b) [4:388] **Accounting standards:** If the corporation has 100 or more shareholders, the annual report must be prepared in accordance with "generally accepted accounting principles." But the financial statements of corporations with fewer than 100 shareholders need *not* conform to such standards—as long as they reasonably set forth the corporation's assets, liabilities, income and expenses, and disclose the accounting basis used in their preparation. [Corps.C. §§ 114, 1501(a)(3); *see ¶ 6:547 ff.*]

(b) [4:389] **When bylaws may dispense with annual report:** If the corporation has *fewer than 100 shareholders* of record (as determined under Corps.C. § 605), the bylaws may *waive* the requirement that the corporation furnish an annual report to its shareholders. [Corps.C. § 1501(a)(1)]

➪ [4:390] ***PRACTICE POINTERS:*** Be sure to mention this if the organizers are planning a closely-held corporation. If all of them plan to be active in the business, an annual report may be a needless formality and expense. In such case, an express waiver of Corps.C. § 1501(a)(1) should be included in the bylaws.

On the other hand, if any of the organizers indicates reluctance re waiving an annual report, this may be a warning that such reports will be subject to special scrutiny. In such case, you may wish to consider the advisability of adding a provision to the bylaws requiring the annual report to be prepared by independent public accountants, rather than corporate officers. (Ideally, such reports should be *certified* by the accountants, but the cost of certification usually makes it impractical for small corporations.)

(c) [4:391] **Shareholders' right to financial statements where no annual report furnished:** If an annual report has not been sent to the shareholders (whether due to the corporation's neglect or because the bylaws waive the requirement for such reports), *any* shareholder has the right to financial statements from the corporation upon written request made 120 days or more after the close of the fiscal year. The corporation must provide the shareholder with the same information as required for the annual report (*¶ 4:386*) within 30 days after receiving such request. [Corps.C. § 1501(c); *see ¶ 6:550*]

[4:392] Furthermore, shareholders holding at least 5% of any class of outstanding shares, upon written request, are entitled to obtain *interim* (quarterly) *income statements* and *balance sheets*. Copies of all financial statements must be maintained on file at the corporation's principal office for 12 months and must be exhibited at all reasonable times to any shareholder seeking an examination of them, or a copy must be mailed to such shareholder. [Corps.C. § 1501(c); *see ¶ 6:552 ff.*]

(d) [4:393] **Enforcement of shareholders' right to annual report:** The Superior Court of the county in which the corporation has its principal office is empowered to enforce the corporation's duties of delivering such financial information and statements. If the court finds that the corporation has failed to comply with the statutory requirements, the requesting shareholders may be reimbursed for their reasonable expenses, including attorney fees, in connection with enforcing such compliance. [See Corps.C. § 1501(e), (f); *see ¶ 6:554 ff.*]

[4:393.1 - 4:393.4] *Reserved.*

(e) [4:393.5] **Annual benefit report (benefit corporations):** A benefit corporation must deliver to its shareholders an annual *benefit* report in addition to or with the annual report. The benefit report must also be posted on any Internet

website maintained by the benefit corporation. If the corporation does not have an Internet website, the *most recent* benefit report must be provided without charge to *any person* requesting the report. (The annual benefit report *cannot be waived* by the shareholders.) [Corps.C. §§ 14621, 14630; *see detailed discussion at ¶ 9:600 ff.*]

(5) [4:394] **Annual information statement filed with Secretary of State:** The bylaws commonly recite the statutory requirement imposed upon every California corporation to file an annual information statement with the Secretary of State. The initial statement must be filed within 90 days after filing of the corporation's original articles and annually thereafter. [See Corps.C. § 1502(a); *and ¶ 6:557*]

(Every foreign corporation qualified to do business in California must file a comparable statement; see Corps.C. § 2117.)

[4:395 - 4:396] ***Reserved.***

h. [4:397] **Bylaws relating to "emergency":** The bylaws may contain special provisions to manage and conduct the corporation's ordinary business affairs in an "emergency" (¶ 4:397.1). Such provisions are effective only during the "emergency" and may not conflict with the articles. All other bylaw provisions consistent with the "emergency" provisions remain in effect during the "emergency." [Corps.C. § 212(c)(1), (3)]

(1) [4:397.1] **"Emergency" defined:** An emergency is an event or circumstance listed below that prevents a quorum of a corporation's board from convening:

• a natural catastrophe, including (but not limited to) a hurricane, tornado, storm, high water, wind-driven water, tidal wave, tsunami, earthquake, volcanic eruption, landslide, mudslide, snowstorm, drought, epidemic, pandemic, or disease outbreak;

• any fire, flood, or explosion, regardless of cause;

• an attack "by an enemy" of the state or the United States, or a warning from the federal government that an enemy attack is probable or imminent;

• a terrorist attack or other manmade disaster that results in extraordinary levels of casualties or damage or disruption severely affecting the infrastructure, environment, economy, government functions, or population (including mass evacuations);

• a state of emergency proclaimed by the Governor or the President. [Corps.C. § 207(i)(5)]

(2) [4:397.2] **Specific provisions:** The "emergency" bylaws may contain special procedures for calling a board meeting, quorum requirements for a board meeting, and designating additional or substitute directors. [Corps.C. § 212(c)(1); *see* ¶ *4:305.1, 4:315.1*]

The Code expressly confers upon the corporation the power, during *or in anticipation of* an "emergency," to (a) modify lines of succession to accommodate the incapacity of any director, officer, employee or agent resulting from the "emergency," and (b) relocate the principal office, designate alternative principal or regional offices, or authorize the officers to do so. "Emergency" bylaws may, however, alter these statutory provisions. [Corps.C. § 207(i)(1)]

(3) [4:397.3] **Limitation where shareholder approval required:** During an "emergency" (¶ 4:397.1), the board may take necessary and appropriate action to respond to the emergency, mitigate its effects, or comply with lawful federal and state government orders. However, the board may not take any action that requires a shareholder vote, unless the required vote of the shareholders was obtained before the emergency. [Corps.C. § 212(c)(2); see Corps.C. § 207(i)(3)]

(4) [4:397.4] **No liability for "good faith" acts:** Corporate action taken in accordance with "emergency" bylaw provisions binds the corporation and may not be used to impose liability on a corporate director, officer, employee or agent. [Corps.C. § 212(c)(4)]

[4:397.5 - 4:397.10] ***Reserved.***

i. [4:397.11] **Bylaws relating to shareholder disputes:** Many publicly traded corporations have adopted bylaw provisions governing shareholder disputes relating to the corporation's "internal affairs." Although such provisions may be inserted

in the articles, they are more typically included in the bylaws pursuant to the corporation's general power to adopt bylaw provisions for the conduct of corporate affairs. [See Corps.C. § 212(b); *see also* ¶ *4:189*]

If not included in the original bylaws, these provisions are usually adopted by the board of directors. *See* ¶ *4:180 ff.*

(1) [4:397.12] **Provision selecting litigation forum:** The typical forum-selection provision designates the courts of the state of incorporation as the sole and exclusive forum for (a) any derivative action or proceeding brought on the corporation's behalf, (b) any action asserting a claim for breach of fiduciary duty owed by any director, officer or other employee of the corporation to the corporation or its shareholders, (c) any action asserting a claim arising under any provision of the California General Corporation Law, or (d) any action asserting a claim governed by the "internal affairs" doctrine (¶ 3:4.1 ff.). [See *Drulias v. 1st Century Bancshares, Inc.* (2018) 30 CA5th 696, 705-711, 241 CR3d 843, 850-856—bylaw of Delaware corporation headquartered in California selecting Delaware courts as forum for shareholder disputes valid under Delaware law (per Corps.C. § 2116 and "internal affairs" doctrine, ¶ 3:4.1 ff.) even though adopted by directors (not by shareholders) after directors' alleged wrongdoing; *Salzberg v. Sciabacucchi* (Del. 2020) 227 A3d 102, 114-115—federal forum provision (FFP) in certificate of incorporation that designated federal courts as exclusive forum for resolving securities claims facially valid and did not violate Delaware laws or policies; *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* (Del.Ch. 2013) 73 A3d 934, 950-963—bylaw selecting Delaware state and federal courts as forum for resolving shareholder disputes valid so long as not used unreasonably and unjustly]

Caution: The California Supreme Court has granted review to decide whether a forum selection clause is enforceable when a party's right to a jury trial under *California* law for their civil claims would not apply in the forum identified by the clause. [See *EpicentRx, Inc. v. Sup. Ct.* (2023) 95 CA5th 890, 313 CR3d 782, rev.grntd. 12/13/23 (Case No. S282521)]

(a) [4:397.12a] **Comment:** No California court has yet addressed the validity of a forum-selection provision in a *California* corporation's articles or bylaws designating the California courts for resolution of disputes involving the matters specified above (¶ 4:397.12). However, the *Drulias* court expressly found that the Delaware forum-selection bylaw at issue in that case did not conflict with California law or public policy. [See *Drulias v. 1st Century Bancshares, Inc.* (2018) 30 CA5th 696, 705-711, 241 CR3d 843, 850-856]

(2) [4:397.13] **Provision shifting attorney fees:** A fee-shifting bylaw typically mandates that where a shareholder asserts a claim or counterclaim against the corporation or its directors or officers, or brings a derivative action on behalf of the corporation against its directors or officers, and the shareholder does not obtain a judgment on the merits that awards the shareholder "substantially" what the shareholder seeks, the shareholder must reimburse the corporation and the other defendants for all fees, costs and expenses, including reasonable attorney fees, that they may incur in connection with the asserted claims. [See *Solak v. Sarowitz* (Del.Ch. 2016) 153 A3d 729, 740-743 (discussing 2015 legislation that added Del.Gen.Corp.L. § 109(b) banning bylaw fee-shifting provision with respect to "internal corporate claim")]

(3) [4:397.14] **Mandatory arbitration of disputes:** An arbitration provision typically requires that all disputes brought by or on behalf of any shareholder of the corporation, whether as an individual, class, or derivative action, shall, on the demand of any party to the dispute, be resolved through "binding and final" arbitration before a designated arbitral forum. [See *Cobb v. Ironwood Country Club* (2015) 233 CA4th 960, 965-966, 183 CR3d 282, 286-287—bylaw requiring mandatory arbitration unenforceable when adopted 4 months after and in response to member's dispute with country club]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 4-E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

E. Postincorporation Action by Incorporators

1. [4:398] Actions Required to Complete Organization
2. [4:400] Other Postincorporation Action by Incorporators
3. [4:402] How Incorporators Take Such Action

1. [4:398] **Actions Required to Complete Organization:** There are two situations in which the incorporators *must* take action in order to complete organization of the corporation:

• Where the articles of incorporation do not name the initial directors, the incorporator(s) must designate and appoint them (*¶ 3:421*).

• And if the articles do not designate the number of directors, the incorporator(s) will have to adopt a bylaw specifying the number of directors *before* they designate and appoint the initial directors (¶ 4:276).

➪ [4:399] ***PRACTICE POINTER:*** Be *careful* in this area. If you have decided not to include the number or names of the initial directors in the articles of incorporation, make sure that the incorporators adopt a bylaw fixing the authorized number of directors and designate the initial directors *before* the organizational meeting of the board.

The critical importance of these steps cannot be overemphasized. Errors in these procedures may result in the initial directors (and their successors) never having been "duly elected," casting doubt on the validity of all ensuing corporate actions.

The risks here are so serious that some experienced lawyers prefer to *include* the number and names of the initial directors in the articles of incorporation … unless there is a very strong reason for *not* doing so.

2. [4:400] **Other Postincorporation Action by Incorporators:** In addition to the above (*¶ 4:398 ff.*), the incorporators may take any other postincorporation action they deem "necessary and proper to perfect the organization of the corporation"—specifically including adoption and amendment of bylaws and the election of officers and directors. [Corps.C. § 210]

Prior to naming (or electing) directors and issuing shares, the incorporators may also amend or restate the articles of incorporation. [Corps.C. §§ 910(b), 901, 906]

Conceivably, the incorporators could also adopt a form of share certificate and corporate seal; fix the location of the corporation's principal office (if not specified in the articles); adopt a fiscal year for the corporation, etc. [See Corps.C. § 210]

➪ [4:401] ***PRACTICE POINTER:*** Leave all such discretionary matters to the initial directors. The incorporators have no ongoing management powers or responsibilities, and whatever action they take may only have to be undone by the directors.

3. [4:402] **How Incorporators Take Such Action:** Action may be taken by the incorporator(s) either at a meeting or by unanimous written consent without a meeting. If such action is taken at a meeting, the procedural rules relating to board of director meetings (*¶ 4:296 ff.*) apply. [Corps.C. § 307(c)]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[4:403] Thus, a majority of the incorporators constitutes a quorum for the purpose of such incorporators' meeting; and action taken by a majority of the incorporators present at a meeting duly held at which a quorum is present is the act of the incorporators. [Corps.C. § 307(a)(7), (8)]

[4:404] Where the incorporators take action *without* a meeting, it must be by *unanimous* written consent. [Corps.C. § 307(b)]

• ***FORM:*** Minutes of Action by Incorporators, *see Form 4:C*.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 4-F

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

F. Organizational (Initial) Meeting of Directors

1. [4:405] Necessity for Organizational Meeting of Directors
    a. [4:406] Unanimous written consent in lieu of meeting
2. [4:408] Time of Meeting
3. [4:410] Place of Meeting
4. [4:412] How the Organizational Meeting is Called and Noticed
    a. [4:413] Where bylaws previously adopted by incorporators
    b. [4:414] Where no bylaws adopted prior to meeting
        (1) [4:415] Who may call initial meeting
        (2) [4:416] Notice of organizational meeting
        (3) [4:417] Waiver of notice
            (a) [4:418] Effect
5. Agenda for Organizational Meeting of Directors
    a. [4:420] Attorney's role
    b. [4:422] Establishing that meeting duly constituted
        (1) [4:423] Required quorum
        (2) [4:423.1] Notice or waiver
    c. [4:424] Presentation and filing of articles of incorporation
    d. [4:425] Designation of agent for service of process
    e. [4:426] Action on bylaws
    f. [4:427] Election of officers
        (1) [4:428] Required officers
        (2) [4:431] Authorizing employment agreements for officers
        (3) [4:432] Directors serving also as salaried officers
    g. [4:433] Adoption of corporate seal
    h. [4:434] Adoption of form of share certificate(s)
    i. [4:435] Establish principal office
    j. [4:437] Direct filing of annual statement with Secretary of State
    k. [4:438] Direct filing of S election, if applicable
        (1) [4:439] Comment
        (2) [4:439.1] *FORM*
    l. [4:441] Select taxable year (non-S corporations)
    m. [4:443] Establish bank accounts
        (1) [4:444] Designation of persons authorized to sign checks or withdrawals

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [4:445] Fixing limit on authority of specified persons
(3) [4:446] Use of standard bank signature card forms
n. [4:448] Authorize payment of incorporation expenses and reimbursement of advances
o. [4:449] Adoption of any preincorporation contracts or commitments
(1) [4:450] Indemnification of promoters
p. [4:451] Authorize other proposed transactions
(1) [4:452] Limitation—"interested director" transactions
q. [4:453] Authorize borrowings; issuance of debt securities
(1) [4:454] Tax considerations
(2) [4:455] Securities law considerations
(3) [4:455.1] Resolution authorizing debt instruments
r. [4:456] Authorize issuance of shares
(1) [4:457] Resolution authorizing sale and issuance
(a) [4:458] Lawful consideration for shares
(b) [4:459] Importance of describing consideration for issuance of shares
(c) [4:460] Importance of determining dollar value of noncash consideration
(d) [4:463] Special problems where stock issued for past services
(2) [4:464] Resolution directing officers to qualify sale under California Corporate Securities Law
(a) [4:465] Where no exemption available
(b) [4:466] Specifying exemption under which shares will be issued
(3) [4:468] Resolution stating shares being issued pursuant to IRC § 1244
6. [4:470] Completing and Filing Minutes

1. [4:405] **Necessity for Organizational Meeting of Directors:** It is the responsibility of the initial directors (named in the articles or, if not, those subsequently designated by the incorporators) to complete the corporate organization: i.e., adopting bylaws, electing corporate officers, approving the form of share certificate and corporate seal (if any), authorizing the depositories for corporate funds, paying organizational expenses, and authorizing issuance of the corporation's shares and any debt securities, etc.

a. [4:406] **Unanimous written consent in lieu of meeting:** Any action required or permitted to be taken by the board of directors, including actions required to be taken at the organizational meeting, may be taken without a formal meeting if *all* board members sign a written consent thereto. The written consent must be filed in the corporate minutes book. [Corps.C. § 307(b); *see* ¶ *4:310 ff.*]

➪ [4:407] ***PRACTICE POINTER:*** Handling the initial organization of the corporation by written consents in lieu of a formal meeting is *not* generally recommended.

Holding a formal meeting serves several salutary purposes: It impresses upon the directors the importance of corporate formalities, and usually makes them more aware of their responsibilities (*see* ¶ *6:243*). It also permits you to guide the directors through the organizational process, explaining the significance of the matters acted upon, and giving you the opportunity to answer questions from each of the persons present. This tends to solidify your relationship with the principals more effectively than simply having them sign written consents.

2. [4:408] **Time of Meeting:** There is no statutory requirement as to how soon after incorporation the organizational meeting must be held. But the corporation must file with the Secretary of State, *within 90 days after filing its articles* of incorporation (and annually thereafter), a statement of general information; see Corps.C. § 1502, ¶ *4:474*. This statement requires the names and addresses of the directors *and* certain officers, as well as certain other information which can be supplied only after such matters have been determined at the initial meeting of the directors. [Corps.C. § 1502(a)]

➪ [4:409] ***PRACTICE POINTER:*** Hold the organizational meeting of the board *as soon as possible* after the articles of incorporation have been filed. There are several reasons for this:

- If there are preincorporation subscription agreements in effect, the subscriptions may be revoked if the corporation fails to proceed with reasonable diligence to issue the shares subscribed for (*see* ¶ *3:385*).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Until the corporation's organization is complete and it issues shares, the incorporators and initial directors are particularly vulnerable to alter ego liability to creditors of the corporation (*see ¶ 2:50 ff.*).

3. [4:410] **Place of Meeting:** Meetings of the board of directors, including the initial organizational meeting, may be held anywhere (inside or outside California) designated in the notice of the meeting; or, if not stated in the notice, wherever designated in the bylaws. [Corps.C. § 307(a)(5); *¶ 4:298*]

➪ [4:411] ***PRACTICE POINTER:*** It is customary for the organizational meeting to be held either at the corporation's principal office or at the office of the attorney who has prepared the agenda and ordinarily will be preparing and finalizing the minutes of the meeting.

Where feasible, it is recommended that you hold the meeting in your office. Again, it serves to emphasize the importance of corporate formalities, and to solidify your relationship with each of the directors.

4. [4:412] **How the Organizational Meeting is Called and Noticed:** The organizational meeting of directors must be properly convened.

a. [4:413] **Where bylaws previously adopted by incorporators:** If the articles do not designate the number and names of the initial directors, the organizational meeting of the board cannot be held until after the incorporators have adopted a bylaw fixing the authorized number of directors, and then have designated and elected the initial directors (*see ¶ 4:399*).

Where the incorporators have adopted full bylaws, the bylaws will normally include procedures for calling regular and special meetings of the board of directors, including the organizational meeting of the board.

b. [4:414] **Where no bylaws adopted prior to meeting:** In contrast, where the articles specify the number and names of the initial directors, there is no need for the adoption of bylaws prior to the organizational meeting of the board.

Instead, the meeting is called and noticed in accordance with the statutory provisions below (¶ 4:415 ff.).

(1) [4:415] **Who may call initial meeting:** The initial meeting of the directors may be called by any two directors named in the articles (or elected by the incorporators). [See Corps.C. § 307(a)(1)] (Of course, if the corporation has but a single director designated, that individual may take action unilaterally, either at a meeting or by simple written consent.)

(2) [4:416] **Notice of organizational meeting:** The organizational meeting is subject to the same notice requirements as any special meeting of the directors: i.e., unless notice is waived (and it usually is, *see ¶ 4:417*), there must be at least four days' notice by mail, or 48 hours' notice if delivered personally or by telephone (including a voice messaging system) or by fax, email or other electronic transmission by the corporation (¶ 4:199.8 ff.). The notice need simply state the time and place of the meeting; it need not specify the purpose or agenda. [Corps.C. § 307(a)(2); *see ¶ 4:304 ff.*]

(3) [4:417] **Waiver of notice:** Notice need not be given to any director who provides a written waiver of notice, or consent to holding the meeting, or an approval of the minutes, whether *before or after* the meeting. (Moreover, notice is waived if any director attends the meeting without protesting the lack of notice.) All such waivers, consents and approvals are filed as part of the minutes of the meeting. [Corps.C. § 307(a)(3); *¶ 4:309*]

(a) [4:418] **Effect:** As long as a quorum of the directors is present, any action taken at a board meeting (however noticed or called) is valid if each of the directors not present ultimately signs a waiver of notice or consent to holding the meeting, or approval of the minutes.

➪ [4:419] ***PRACTICE POINTER:*** It is usually a good idea to use a waiver of notice for the organizational meeting, rather than sending out formal notice. This will familiarize the directors with using waivers to validate board meetings held in the future without formal notice and may avoid problems of defective notice.

• ***FORM:*** Waiver of Notice and Consent to Holding of Organizational Meeting of Board of Directors, *see Form 4:D.*

5. Agenda for Organizational Meeting of Directors

a. [4:420] **Attorney's role:** Typically, the attorney will prepare the agenda, or even a draft of proposed minutes for the organizational meeting. Before developing the agenda or preparing any draft minutes, counsel should ascertain from the

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

clients if there are any matters likely to arise at the meeting in *addition* to the traditional agenda item matters set forth below (¶ 4:422 ff.).

➪ [4:421] ***PRACTICE POINTER:*** Preprinted organizational minutes are often supplied with corporate kits. However, care must be taken in using these form minutes, to make sure that the form provisions are suitable, and that they cover *all* of the matters that need to be dealt with at the organizational meeting. That is rare. Almost invariably, the forms supplied have to be modified. Therefore, it is better practice to develop your own organizational minutes, tailored to the needs of the particular corporation.

- ***FORM:*** Draft Organizational Minutes, *see Form 4:E*.

b. [4:422] **Establishing that meeting duly constituted:** At the commencement of the meeting, the directors present, as well as those absent, should be identified so that this information can be stated in the minutes of the meeting. One of the directors present should be elected to serve as chairperson of the meeting and another to serve as secretary of the meeting. The presence of any other persons at the meeting (such as the attorney) should also be noted to be set forth in the minutes.

(Rather than meet face-to-face, the directors can meet through conference telephone call or other communications equipment (e.g., electronic video screen); *see ¶ 6:210*. But, for much the same reasons that an initial *meeting* is preferable to an action by written consent (*see ¶ 4:407*), it is highly desirable that the initial organizational meeting be held in person.)

(1) [4:423] **Required quorum:** The chairperson should also assure the presence of enough directors to constitute a quorum to take action at the meeting, and announce to the meeting the numbers required to constitute a quorum. (By statute, a majority of the authorized number of directors constitutes a quorum unless the articles require more. Either the articles or bylaws may reduce the quorum requirement to as little as one-third the authorized number. See Corps.C. § 307(a)(7), *and ¶ 4:311 ff.*)

(2) [4:423.1] **Notice or waiver:** The chairperson should then present to the meeting the written "Waiver of Notice and Consent to Holding of Organizational Meeting of Board of Directors" (*see Form 4:D*) signed by each director of the corporation, and instruct the secretary to make such written waiver and consent a part of the records of the meeting, and declare a quorum present and that the meeting is duly constituted.

In the alternative, if the meeting is being held upon formal notice given, the chairperson should present a copy of such notice together with a statement of the manner in which the notice was served, instructing the secretary to insert a copy of such notice in the minutes book accompanying the minutes of the meeting.

c. [4:424] **Presentation and filing of articles of incorporation:** The chairperson should announce the date the corporation's articles were filed with the Secretary of State (i.e., the date of incorporation), and present to the meeting a certified copy of such articles, directing the secretary to insert it in the minutes book.

d. [4:425] **Designation of agent for service of process:** It is desirable, although not necessary, that the board of directors confirm and ratify the designation by the incorporator(s) of the agent for service of process set forth in the articles of incorporation (*see ¶ 4:23*).

If the board wishes to designate someone other than the agent designated in the articles, it may do so by resolution. The agent so designated must be set forth in the initial statement required to be filed with the Secretary of State within 90 days after the filing of the corporation's original articles under Corps.C. § 1502 (*¶ 4:474*).

e. [4:426] **Action on bylaws:** If bylaws have been adopted previously by the incorporators (*see ¶ 4:400*), those bylaws should be presented to the meeting. (However, this is simply a formality; there is no statutory requirement that the directors approve bylaws previously adopted by the incorporators.) [See Corps.C. § 210]

Where no bylaws have yet been adopted (as is usually the case), the bylaws prepared by counsel should be presented for adoption by the directors at the organizational meeting. [See Corps.C. §§ 210, 211]

f. [4:427] **Election of officers:** The directors at their organizational meeting should appoint persons to serve in each corporate office. The titles and duties of the corporate officers should be stated in the bylaws or otherwise determined by the board of directors. [Corps.C. § 312(a), (b); *see ¶ 4:328 ff.*]

(1) [4:428] **Required officers:** As discussed earlier, the corporation must have:

- A chairperson (or chair) of the board, and/or a *president*;

- A *secretary*; and

• A *chief financial officer*. [Corps.C. § 312(a); ¶ 4:329]

[4:429] Other officers, such as one or more vice-presidents, assistant secretaries, or assistant treasurers, may be designated either in the bylaws or by resolution of the board. The same person may occupy more than one corporate office, unless the bylaws provide otherwise. [Corps.C. § 312(a); *see* ¶ *4:330*]

[4:430] ***Reserved.***

(2) [4:431] **Authorizing employment agreements for officers:** Where officers are to serve under employment agreements with the corporation, such agreements should be approved and authorized by resolution of the board.

(3) [4:432] **Directors serving also as salaried officers:** If any of the directors is to receive compensation as an officer, their vote cannot be counted in approving such compensation. But their presence at the meeting does not affect the validity of whatever compensation arrangement is adopted. [Corps.C. § 310(a); see "interested director" transactions, ¶ *6:286 ff.*]

g. [4:433] **Adoption of corporate seal:** Although a corporate seal is no longer required in California, some corporations still adopt seals. This is because financial institutions may continue to require that a corporate seal be affixed to various instruments executed by the corporation (even though failure to affix a seal has no effect on the instrument's validity; Corps.C. § 207(a)). The form of corporate seal should be adopted and approved by resolution of the board of directors.

h. [4:434] **Adoption of form of share certificate(s):** Unless the corporation has adopted a system of share issuance, registration and transfer by book entry (¶ 5:472), every holder of shares in a California corporation is entitled to have a certificate certifying the number of shares and the class or series of shares owned by the shareholder. The certificate must be signed in the name of the corporation by the chairperson or vice-chairperson of the board, or the president or a vice-president, *and also* by the chief financial officer or an assistant treasurer, or the secretary or any assistant secretary. [Corps.C. § 416(a); *see* ¶ *5:444*]

The form of such share certificate for each class or series of shares to be issued by the corporation, should therefore be formally adopted and approved by resolution of the board of directors.

i. [4:435] **Establish principal office:** The corporation will be required to designate its principal office in the information statement filed with the Secretary of State within 90 days after incorporation (see Corps.C. § 1502, ¶ *4:474 ff.*). The bylaws may establish the location for the corporation's principal office; if not, the board of directors may adopt a resolution fixing such location. [See *Rosas v. Sup.Ct. (Mercury Cas. Co.)* (1994) 25 CA4th 671, 672, 677, 30 CR2d 609, 610, 613—designation of principal office in information statement binding on corporation for CCP § 395.5 venue purposes]

➪ [4:436] ***PRACTICE POINTER:*** It is usually better to have the board of directors fix the location of the corporation's principal office. This avoids having to amend the bylaws if the corporation moves its head office (a common occurrence). The change of location can be reflected in a later resolution of the board.

➪ [4:436.1] ***CAUTION:*** Counsel should beware of accommodating a client who wishes to use the attorney's office as the corporation's principal business address. The attorney will bear the responsibility of reviewing or forwarding all corporate correspondence (including "junk mail"), as well as formal notices that may require prompt attention (*see* ¶ *6:560 ff.* for penalties regarding late annual statements). And once the attorney's address appears in the Secretary of State's records, any change requires both corporate action and filing of a new statement of information. As in the case of acting as agent for service of process (¶ 3:417), acting as the corporation's principal office imposes due care duties—and potential liability—but without any corresponding benefits.

j. [4:437] **Direct filing of annual statement with Secretary of State:** As mentioned earlier, a new corporation is required to file a statement of general information with the Secretary of State within 90 days after incorporation (and annually thereafter). [Corps.C. § 1502, ¶ *4:474*]

It is customary (although not essential) for the board to adopt a resolution directing the secretary or other corporate officer to prepare and file the requisite statement. And, it may serve as a reminder to counsel and the corporate officers of the 90-day deadline.

k. [4:438] **Direct filing of S election, if applicable:** If the corporation intends to elect S status for income tax purposes (in order to pass start-up losses through to the shareholders), it will have to file a timely election with the Internal Revenue Service. [See IRC §§ 1371-1379, *discussed at* ¶ *2:119 ff.*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

It is customary (although again not essential) for the board to adopt a resolution directing the secretary or other corporate officer to prepare and file the requisite election. Also, this will serve as a reminder to counsel and the corporate officers to consider the advisability of filing the S election. There are strict time limits within which it must be filed; *see ¶ 4:482*.

(1) [4:439] **Comment:** Often, the clients have not made up their minds at the time of the organizational meeting whether they want the corporation to file its tax returns under Subchapter S (because they don't know yet whether there will be any losses to pass through to them).

In such cases, it is still better to file the election. Waiting until later may prevent S status during the first year. If it turns out that the corporation does not want S status, there are ways in which the election can be terminated (*see ¶ 2:152*).

(2) [4:439.1] ***FORM:*** See Resolution Directing S Election contained in Draft Organizational Minutes, *Form 4:E*.

➪ [4:440] ***PRACTICE POINTER:*** The preparation and filing of the S election may be left to the corporation's officers or even to its accountant. But if so, the resolution should be drafted accordingly—i.e., the resolution should make it clear *who* has the responsibility for filing the election. Hopefully, this will avoid misunderstandings and slip-ups.

l. [4:441] **Select taxable year (non-S corporations):** If the corporation elects S status, it will have to adopt the same taxable year as its shareholders (*see ¶ 2:150*).

But if it is *not* going to file under Subchapter S, it may adopt its own taxable year without regard to the taxable year of its shareholders. The corporation's taxable year may be either a calendar year or a fiscal year ending on the last day of any calendar month. The selection of the taxable year should reflect various tax and nontax considerations discussed at *¶ 4:484 ff.*

It is customary (although again not essential) for the board to adopt a resolution selecting the corporation's fiscal year at the organizational meeting.

➪ [4:442] ***PRACTICE POINTER:*** In many cases, the organizational meeting is too soon to make an intelligent selection of the fiscal year, and the matter should be deferred until the corporation's operations are under way.

Note that the selection of fiscal year by a newly-organized corporation does *not* require any filing or approval by the Internal Revenue Service or Franchise Tax Board (*see ¶ 4:486*).

m. [4:443] **Establish bank accounts:** The board must authorize the opening of corporate bank accounts in which to deposit the initial cash received from issuance of its shares or other securities, and in which to make periodic trust deposits for the withholding of federal and state income taxes, social security taxes, and quarterly deposits on account of the corporation's estimated corporate income tax liability.

(1) [4:444] **Designation of persons authorized to sign checks or withdrawals:** The board resolution should specify which officers are authorized to sign checks or make withdrawals on the various corporate bank accounts. The resolution should state whether two signatures are required, or whether a single designated officer is authorized to make withdrawals.

(2) [4:445] **Fixing limit on authority of specified persons:** For reasons of fiscal control and accountability, the board may wish to limit the amount of any check or withdrawal any of the signatories is authorized to make, or to require multiple signatures for checks or withdrawals in excess of a certain specified amount.

(3) [4:446] **Use of standard bank signature card forms:** Most banks furnish their own printed signature card form which contains the form of resolution they require to be adopted by a corporation opening an account with them. Rather than prepare some other form of resolution, the form of resolution required by the bank should be utilized and adopted by the board.

➪ [4:447] ***PRACTICE POINTER:*** The clients will usually have selected a bank at which they plan to open corporate accounts. Ask them to provide you with copies of the signature cards and resolution forms used by their bank. If the cards have not yet been executed, you can assist the clients in filling them out (and noting any limitations on dollar amount authority or number of signatures). And you can simply paste a duplicate copy of the signature card and resolution form in the minute book (rather than having it typed in); or, alternatively, you can adopt a resolution authorizing opening of the bank account and adopting the bank's "standard form" resolutions.

n. [4:448] **Authorize payment of incorporation expenses and reimbursement of advances:** The chairperson should report to the board on the amount of fees and other expenses incurred in connection with incorporating and organizing the corporation, and the board should authorize the payment of any balance due on such expenses and reimbursement to the attorney or other persons who have advanced funds to the corporation for such purposes.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

o. [4:449] **Adoption of any preincorporation contracts or commitments:** Where the promoters, in anticipation of completing the corporate formation, have entered into contracts or commitments on behalf of the corporate business being organized, it is appropriate for the corporation to adopt and ratify any such contracts or commitments and thereby become bound by them. (As to liability of corporation on promoters' contracts, *see* ¶ *3:398*.)

(1) [4:450] **Indemnification of promoters:** Absent a "novation" (¶ *3:401.1*), corporate ratification does not extinguish the promoters' personal liability on preincorporation commitments. Therefore, in connection with its acceptance and ratification, it is also appropriate for the corporation to *indemnify* the promoters against personal liability arising under their preincorporation transactions (¶ *3:399*).

• ***FORM:*** See Resolution Ratifying Preincorporation Transactions contained in Draft Organizational Minutes, *Form 4:E*.

p. [4:451] **Authorize other proposed transactions:** At its initial meeting, the board should also consider and act upon other proposed or pending transactions, such as: lease of office space, purchase of equipment, etc.

(1) [4:452] **Limitation—"interested director" transactions:** If the property being purchased or leased belongs to one of the directors, there are self-dealing limitations to consider, and voting procedures to be observed. (See "interested director" transactions, Corps.C. § 310(a), ¶ *6:286 ff.*)

q. [4:453] **Authorize borrowings; issuance of debt securities:** If the corporation will be raising capital by borrowing from third parties or from shareholders, or establishing lines of credit with suppliers or the like, these transactions should be formally authorized by resolution of the board.

(1) [4:454] **Tax considerations:** To assure that such borrowings constitute bona fide debt and the deductibility of any interest payments thereon for tax purposes, care must be taken to satisfy the "debt equity ratio" requirements of IRC § 385 and the suggested "debt-equity ratio" discussed at ¶ *3:41*.

(2) [4:455] **Securities law considerations:** Moreover, if the borrowings involve the issuance of *debt securities*, care must be taken to assure that the transactions are in compliance with federal and state securities laws (*see* ¶ *5:32*).

(3) [4:455.1] **Resolution authorizing debt instruments:** The board should adopt a resolution specifying:

• The *name* of each creditor or lender from whom the corporation is authorized to borrow;

• The *amount* which it is authorized to borrow, and the *terms and conditions* upon which the debt is to be repaid (interest rate, maturity, security for repayment, etc.);

• If the debt is for other than cash loaned to the corporation, a description of the type and agreed dollar value of the *consideration* for which the debt is incurred;

• A description of the *type of debt instrument* to be issued by the corporation to evidence the debt (e.g., promissory note, revolving credit note, etc.);

• A description of any *security* to be given;

• Applicable securities law exemption(s) being relied upon (as in the case of share issuances; *see* ¶ *4:466*).

FORM: See Resolution Authorizing Borrowings contained in Draft Organizational Minutes, *Form 4:E*.

r. [4:456] **Authorize issuance of shares:** To obtain capital for the corporation, the board must authorize the sale and issuance of the corporation's shares. The amount of shares, and the classes or series of such shares which may be issued are, of course, established in the articles of incorporation (*see* ¶ *4:28 ff.*). The sale and issuance thereof must be authorized as follows:

(1) [4:457] **Resolution authorizing sale and issuance:** First of all, the board should adopt a resolution specifying:

• The *name* of each proposed issuee or the *category* of persons to whom the corporation's shares will be sold (e.g., accredited investors);

• The *number of shares* to be issued to such issuee or category of persons (and the class or series of such shares, if applicable); and

• The type and dollar value of the *consideration* to the corporation for which such shares will be issued.

(a) [4:458] **Lawful consideration for shares:** Basically, shares may be issued for cash, tangible or intangible property, cancellation of existing debt, or services previously rendered. But they may *not* be issued for future services; nor for a promissory note (unless adequately secured by collateral other than the shares themselves). [Corps.C. § 409(a), *discussed at ¶ 3:307*]

(b) [4:459] **Importance of describing consideration for issuance of shares:** To confirm that the consideration for which the shares are being issued is of a permitted type, the board resolution should describe the consideration: e.g., cash; or services previously rendered, with a brief description of such services. Where shares are being issued in cancellation of an existing debt, the resolution should contain a brief summary description of such indebtedness. Similarly, where shares are being issued for either tangible or intangible property, the resolution should describe such property, or such description should be attached as an exhibit to the resolution.

(c) [4:460] **Importance of determining dollar value of noncash consideration:** The board is required by law to state its determination of the fair value to the corporation in monetary terms of any consideration other than money for which shares are issued. [Corps.C. § 409(e)]

[4:461] Such determination should be stated in the resolution authorizing the share issuance. The resolution should set forth the fair dollar value of any consideration (other than cash itself) for which shares are to be issued. In the absence of fraud, the judgment of the directors as to the *value* of the consideration for shares shall be conclusive. [Corps.C. § 409(b), *¶ 3:318*]

➪ [4:462] ***PRACTICE POINTER:*** In drafting the resolution, state *how* the board determined the value of any noncash consideration. The more specific the investigations or appraisals, the more difficult it will be for the creditors or shareholders at some later time to claim "fraud."

(d) [4:463] **Special problems where stock issued for past services:** Shares may be issued for past services, but doing so raises special problems: If the value of such services cannot be clearly established, the shares may be deemed "promotional" shares for securities law purposes and thus subject to special restrictions by the Financial Protection and Innovation Commissioner; *see ¶ 5:329*. Also, the issuance of shares for past services may result in adverse income tax consequences to the issuee—i.e., ordinary income upon receipt; *see ¶ 2:171*.

(2) [4:464] **Resolution directing officers to qualify sale under California Corporate Securities Law:** The directors' resolution authorizing the issuance of shares should expressly condition the sale and issuance upon compliance with the California Corporate Securities Law.

(a) [4:465] **Where no exemption available:** Where no exemption is available for such issuance, the directors' resolution should direct the officers to qualify the sale and issuance of the shares under the Corporate Securities Law; *see ¶ 5:315*.

(b) [4:466] **Specifying exemption under which shares will be issued:** Where the shares will be issued under one of the available exemptions from qualification under the Corporate Securities Law, the directors should specify the particular exemption being relied upon; e.g., California Corporations Code § 25102(h), or § 25102(f), etc.

➪ [4:467] ***PRACTICE POINTER:*** It is also a good idea for the resolution to *state the factual basis* which satisfies the requirements of such exemption. (For example, where the exemption being invoked is Corps.C. § 25102(f), the resolution should set forth a description of the purchasers' preexisting personal or business relationship with the corporation or its specified officers or directors, and/or the financial and business experience and sophistication of the purchaser; *see ¶ 5:256*.) Doing so provides a record for future reference … and also may help avoid your overlooking one or more facts crucial to the exemption.

The resolution should also direct the corporate officers to file any required notice with the California Financial Protection and Innovation Commissioner within the applicable time period for such filing.

• ***FORM:*** See Resolution Authorizing Issuance of Shares and Designation of Exemption contained in Draft Organizational Minutes, *Form 4:E*.

(3) [4:468] **Resolution stating shares being issued pursuant to IRC § 1244:** It is also good practice (although *not* essential) for the directors to state that all stock is being issued pursuant to Section 1244 of the Internal Revenue Code, and to *recite the facts* showing that such stock qualifies under Section 1244: i.e., that at the time of issuance the corporation was a "small business corporation" as defined in IRC § 1244(c)(3); that the stock was issued for money or other *property*; and that the majority of its gross receipts have not and will not be derived from "passive" sources (*see ¶ 2:188 ff.*).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

➪ [4:469] ***PRACTICE POINTER:*** There is no longer any requirement that stock be issued pursuant to a "plan" in order to qualify under IRC § 1244. Even so, adopting a resolution stating that the shares are being issued as § 1244 stock is good practice. It may serve as a reminder to the issuees of the possible tax benefits available to them if the investment results in a loss. And, reciting the facts showing qualification under § 1244 may assist the issuee in documenting their claim for the tax benefits available under that section.

- ***FORM:*** See Resolution Authorizing Stock Issuance Under IRC § 1244 contained in Draft Organizational Minutes, *Form 4:E*.

6. [4:470] **Completing and Filing Minutes:** Counsel should assume responsibility for assuring that the minutes of the organizational meeting of the directors are completed and contain all of the resolutions and other matters dealt with at the meeting.

The minutes should be signed by the secretary of the meeting, and although not required, it is also good practice for the minutes to be signed by the chairperson of the meeting. Directors who were not present at the meeting, and who have not waived notice of a meeting and executed consents to the holding of such meeting in their absence, should also individually sign their consents to the minutes and to all of the actions taken at the meeting.

The minutes should then be inserted in the minutes book of the corporation.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 4-G

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

G. Postorganizational Matters

- 1. [4:474] Filing Information Statement Required by Corps.C. § 1502
  - a. [4:475] Contents
    - (1) [4:475a] Labor Code violations
    - (2) [4:475.1] Optional email address
    - (3) [4:476] Not notice to third persons
  - b. [4:477] Designation of agent for service of process
  - c. [4:478] Changes of information
  - d. [4:479] Electronic filing permitted
  - e. [4:479.5] Filing fee
  - f. [4:479.6] Supplemental statement by publicly-traded corporation
  - g. [4:479.7] Certification required
- 2. [4:480] Filing S Election
  - a. [4:481] Procedure
    - (1) [4:481.1] No California election required
  - b. [4:482] Time limit on filing
    - (1) [4:482.1] Caution—delayed share issuance
    - (2) [4:483] Missed deadline
      - (a) [4:483a] Relief from late filing—private ruling generally required
      - (b) [4:483b] Expedited relief
        - 1) [4:483c] Exception to three-year-75-day deadline
        - 2) [4:483d] S election and supporting documentation
          - a) [4:483e] Execution
        - 3) [4:483f] Filing with IRS Service Center
          - a) [4:483g] Exception to three-year-75-day deadlines
        - 4) [4:483h] IRS response
    - (3) [4:483.1] Late-filed shareholder consent
      - (a) [4:483.5] Failure to provide spousal consent—automatic relief available
        - 1) [4:483.6] Request to file late shareholder consent
        - 2) [4:483.7] IRS response
    - (4) [4:483.10] Effect of election delayed or lost in mail
  - c. [4:483.11] Disqualification as S corporation; reinstatement following inadvertent termination
- 3. [4:484] Selection of Corporation's Taxable Year (Non-S Corporations)
  - a. [4:486] Timing

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- b. [4:487] Tax considerations affecting choice of fiscal year
  - (1) [4:488] Utilizing “short year” return
    - (a) [4:489] Start-up losses
    - (b) [4:490] Seasonal income
  - (2) [4:491] Delaying tax on distributions to officers and shareholders
    - (a) [4:492] Year-end bonuses
    - (b) [4:493] Dividends
    - (c) [4:494] Corporation on accrual basis
      - 1) [4:494.1] Caution re deferred compensation
- c. [4:495] Nontax considerations affecting choice of fiscal year
- d. [4:497] Change of taxable year

4. [4:498] Other Tax Matters
  - a. [4:499] Federal employer identification number
  - b. [4:500] Estimated tax payments
  - c. [4:501] Choosing accounting methods for tax purposes
    - (1) [4:501.1] Caution
  - d. [4:502] Sales and use taxes
  - e. [4:504] Employment taxes
  - f. [4:505] Property taxes
5. [4:506] Business Licenses and Permits
6. [4:508] Insurance Matters
  - a. [4:509] Workers' compensation coverage
  - b. [4:510] Liability insurance
7. [4:511] Compliance With Bulk Sales Statutes
  - a. [4:512] Which businesses
    - (1) [4:513] But *service* businesses, or businesses…
  - b. [4:514] Which sales
    - (1) [4:515] Exemptions
  - c. [4:516] Statutory notice requirement
    - (1) [4:517] Contents
    - (2) [4:518] Recordation and publication
      - (a) [4:518.1] Effect of sale postponement upon notice requirement
    - (3) [4:519] Mailed notice to tax collector
  - d. [4:520] Provision for payment of seller's creditors
  - e. [4:521] Effect of noncompliance with statutory requirements
    - (1) [4:522] “Good faith” exception
    - (2) [4:523] No other liability
      - (a) [4:524] Compare—prior law
    - (3) [4:525] Which creditors
    - (4) [4:526] Buyer's reimbursement right
8. [4:527] Qualifying to Do Business in Other States
  - a. [4:529] Formalities
  - b. [4:530] Professional services
9. [4:531] Corporate Transparency Act
  - a. [4:532] Reporting companies
    - (1) [4:533] Exemptions
  - b. [4:534] Beneficial ownership information
  - c. Required reports and timeframes
    - (1) [4:535] Initial report

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [5:536] Updated reports
(3) [5:537] Electronic reporting
d. [5:538] Access to reported information

[4:471] After the organizational meeting of the board of directors, there are still a number of important matters to be accomplished for the new corporation. First of all, of course, its shares must be issued in compliance with the Corporate Securities Law, as discussed in detail in *Chapter 5*.

[4:472] There are also a variety of other postorganizational matters to be handled, such as obtaining necessary business licenses and permits; filing the information statement required by Corps.C. § 1502; filing an S election (if applicable); selecting the fiscal year; complying with state unemployment insurance and workers' compensation laws, etc. The most important of these matters are summarized briefly in this chapter.

➪ [4:473] ***PRACTICE POINTER:*** Most of these postorganizational matters are customarily handled by the corporate officers or employees, or its accountants, rather than the attorney, because it is more economical for them to do so. However, you should make sure that the clients are aware of these various requirements, and *establish a clear understanding* with them as to whose responsibility it is to follow up on each of these matters. Doing so will minimize the risk that some of these will be overlooked by the clients (and may avoid later dispute with the clients as to whose responsibility it was).

1. [4:474] **Filing Information Statement Required by Corps.C. § 1502:** Every newly-organized corporation must file with the Secretary of State, *within 90 days after filing its original articles* (and annually thereafter, *see ¶ 6:557 ff.*), a statement of general information in accordance with Corps.C. § 1502.

The information is to be provided on a form prescribed by the Secretary of State (Statement of Information (California Stock, Agricultural Cooperative and Foreign Corporations)), which is sent to the new corporation when the articles are filed. (But the failure to receive the form does not excuse the corporation from the filing requirement.) [Corps.C. § 1502(d)]

FORM: Statement of Information (California Stock, Agricultural Cooperative and Foreign Corporations) (SI-550) is available online at the Secretary of State's website (*www.sos.ca.gov*).

a. [4:475] **Contents:** The form requires general information regarding the corporation and its principal officers and directors, including:

• Name of corporation and Secretary of State's file number.

• Names and addresses of directors.

• Number of vacancies (if any) on board.

• Names and addresses of chief executive officer, chief financial officer and secretary.

• Street address of corporation's principal office (and mailing address if different from street address); and if the principal office is outside California, its principal business office within the state.

• Its principal business activity (a general statement suffices; e.g., manufacture of aircraft; wholesale liquor distribution; retail department store). [See Corps.C. § 1502(a)]

(1) [4:475a] **Labor Code violations:** In response to legislative concerns about "wage theft" by employers, the statement of information must include a statement indicating whether any officer or director of the corporation is subject to a final judgment by the California Division of Labor Standards Enforcement or a court of law (for which no appeal is pending) based on a violation of any wage order or Labor Code provision. [Corps.C. § 1502(a)(10), (*l*)(1)] (The section does not define "officer.")

This requirement will also apply to foreign corporations filing statements of information under Corps.C. § 2117 (*see* ¶ 4:394), and to limited liability companies filing statements of information under Corps.C. § 17702.09. [See Corps.C. § 2117(a)(8); Corps.C. § 17702.09(a)(8)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [4:475.1] **Optional email address:** Although Corps.C. § 1502(a)(8) states that the form also allows the corporation the option of providing an email address if the corporation chooses to receive renewal notices (*see ¶ 6:557 ff.*) and other notifications from the Secretary of State by email, the form does not presently contain this option … because the Secretary of State's office does not yet have the capability of sending notices by email.

(3) [4:476] **Not notice to third persons:** Although the statements filed with the Secretary of State are accessible by the public via an online database, they do *not* constitute constructive notice of the matters stated therein—i.e., the statements do not place persons dealing with the corporation on notice of, or under any duty to inquire about, who the officers are or the authorized number of directors, etc. [Corps.C. § 1502(g), (h)]

b. [4:477] **Designation of agent for service of process:** In addition to the general information above (*¶ 4:475*), the form requires designation of an agent for service of process. The designation must show the name and residence or business street address within California of the person designated. If a corporate agent is designated, no address is necessary, but that corporation must have filed a special certificate in compliance with Corps.C. § 1505 (setting forth its offices within California and the names of persons employed at each such office who are authorized to accept process). [Corps.C. § 1502(b)]

c. [4:478] **Changes of information:** Whenever any of the information required by the form is changed, the corporation *may* file a new statement (and to change its agent for service of process, it *must* do so). Otherwise, it can simply wait until the next annual statement is due, and show the changed information on such statement. [Corps.C. § 1502(e)]

d. [4:479] **Electronic filing permitted:** The information statement may be filed electronically, and the filing fee (*¶ 4:479.5*) paid by credit card, at *https://businessfilings.sos.ca.gov*.

[4:479.1 - 4:479.4] ***Reserved.***

e. [4:479.5] **Filing fee:** The fee for filing the statement is $25, payable to the Secretary of State. [Gov.C. § 12186(g); Corps.C. § 1502(i)]

There is no fee for filing *changes* to the statement (*¶ 4:478*). [Gov.C. § 12186(i)]

f. [4:479.6] **Supplemental statement by publicly-traded corporation:** A publicly-traded corporation (i.e., one having a class of securities listed or admitted for trading on a national securities exchange, the OTC Bulletin Board or the OTC Markets Group Inc. electronic service) must also file a supplemental statement within *150 days* after the end of its fiscal year. The supplemental statement (Corporate Disclosure Statement) seeks information regarding the corporation's independent auditor, compensation of directors and top executive officers, loans to directors, directors' and executive officers' bankruptcy filings and fraud convictions, and a description of material legal proceedings. [Corps.C. § 1502.1]

FORM: Corporate Disclosure Statement (SI-PT) is available online at the Secretary of State's website (*www.sos.ca.gov*).

g. [4:479.7] **Certification required:** The corporation must certify that the information contained on the statement (and, if applicable, the supplemental statement (*¶ 4:479.6*)) is *true and correct*. (No claim may be made against the State for any inaccurate information.) [Corps.C. §§ 1502(j), 1502.1(d)]

2. [4:480] **Filing S Election:** A corporation desiring to be taxed as a small business corporation under Subchapter S (IRC §§ 1361-1379; *see discussion at ¶ 2:119 ff.*) must file an election with the Internal Revenue Service.

➪ [4:480.1] ***PRACTICE POINTER:*** Be sure to determine *who* is to be responsible for seeing that the S election is prepared, signed and filed with the IRS within the required time (*¶ 4:482*). Make it clear in writing if you are *not* undertaking this responsibility. All too often, the incorporating attorney "assumes" the clients, or their accountants, are arranging to file an S election … while the clients and/or accountants assume the attorney is doing so. Failure to file the election, and the resulting loss of tax benefits, could result in malpractice liability.

a. [4:481] **Procedure:** A formal election to be taxed under Subchapter S must be filed within the time limit stated below (*¶ 4:482*). The election form requires the written *consents of all of the shareholders* (and of any persons who were shareholders earlier in the year). [IRC § 1362(a)(2) & (b)(2); Treas.Reg. § 1.1362-6(a)(2)]

FORM: Subchapter S Election (Election by a Small Business Corporation) (Form 2553) is available online at the IRS website (*www.irs.gov*).

(1) [4:481.1] **No California election required:** The corporation need not file a Subchapter S election with the Franchise Tax Board: The federal election is valid for California franchise tax purposes. (But a corporation's *revocation* of a federal S election (*see ¶ 2:153*) must be reported to the Franchise Tax Board.) [See Rev. & Tax.C. § 23801(a) & (e)(2)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b. [4:482] **Time limit on filing:** The election and consent must be filed by the 15th day of the third month of the corporation's taxable year. "Taxable year" for this purpose begins whenever the corporation *begins doing business*, or *acquires assets* or *issues shares*, whichever occurs first. [IRC § 1362(b); see Treas.Reg. § 1.1362-6(a)(2); and *Handlery Hotels, Inc. v. Franchise Tax Bd.* (1995) 39 CA4th 1360, 1365, 46 CR2d 525, 528—election effective for Calif. tax purposes in income year in which election made]

(1) [4:482.1] **Caution—delayed share issuance:** Delay in issuing shares could prevent an S election for the initial year. If the corporation acquires assets or commences business operations before issuing shares, the time limit would begin to run, but it could not actually file the election until it has shareholders to sign the consents.

(2) [4:483] **Missed deadline:** An election filed after the deadline for any tax year is treated as an election for the *following year* … unless the corporation can show "reasonable cause" for its failure to make a timely election. [IRC § 1362(b)(3) & (5); Rev. & Tax.C. § 23801(i)]

(a) [4:483a] **Relief from late filing—private ruling generally required:** To establish "reasonable cause" and thereby obtain relief from an untimely late election, a private letter ruling must be obtained … *unless* the corporation qualifies for an expedited procedure (*see ¶ 4:483b*). [See Rev.Proc. 2022-19, 2022-41 IRB 282; Rev.Proc. 2013-30, § 3.02, 2013-36 IRB 173]

(b) [4:483b] **Expedited relief:** In lieu of incurring the time and expense of applying for a private letter ruling (¶ 4:483a), the corporation may use a simpler procedure to file a late S election if it meets the following requirements:

• The failure to qualify as an S corporation was solely because the S election was not timely filed;

• The corporation intended to be an S corporation as of the date the S election is intended to be effective;

• The corporation has "reasonable cause" for the failure to make the timely S election and has acted diligently to correct the mistake upon its discovery;

• The corporation seeks relief within three years and 75 days after the date the S election is intended to be effective (but see exception at *¶ 4:483c*); and

• The corporation and all shareholders reported their income consistent with S corporation status for the year the S election should have been made and for any subsequent taxable years. [Rev.Proc. 2013-30, §§ 4.02(1)-(4), 5.02, 2013-36 IRB 173]

1) [4:483c] **Exception to three-year-75-day deadline:** The three-year-75-day deadline (¶ 4:483b) does not apply where:

• At least six months have elapsed since the date the corporation filed its tax return (Form 1120S) for the first year the corporation intended to be an S corporation; and

• Neither the corporation nor any of its shareholders were notified by the IRS of any problem regarding the S corporation status within six months of the date on which the Form 1120S for the first year was timely filed. [Rev.Proc. 2013-30, § 5.04, 2013-36 IRB 173]

2) [4:483d] **S election and supporting documentation:** The corporation must file an S election (Form 2553, *¶ 4:481*) that states at the top "FILED PURSUANT TO REV.PROC. 2013-30." The S election must include a statement (signed under penalty of perjury) that describes the corporation's reasonable cause for failure to timely file the S election and its diligent actions to correct the mistake upon its discovery. [Rev.Proc. 2013-30, § 4.03(1), 2013-36 IRB 173]

The S election must include statements (signed under penalty of perjury) from all shareholders during the period between the date the S election was to be effective and the date the completed S election is filed that they have reported their income on all affected returns consistent with the S election for the year the election should have been filed and all subsequent years. [Rev.Proc. 2013-30, § 5.02, supra]

a) [4:483e] **Execution:** The S election must be signed by an authorized officer. It must also be signed by all persons who were shareholders at any time during the period that began on the first day of the taxable year for which the election is to be effective and ends on the day the completed S election is filed. [Rev.Proc. 2013-30, § 5.01, supra]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Additionally, the corporation's "reasonable cause" statement and the shareholders' statements (*¶ 4:483d*) must contain a dated declaration stating, "Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." [Rev.Proc. 2013-30, § 4.03(3), supra]

3) [4:483f] **Filing with IRS Service Center:** The S election (and supporting documentation) must be filed with the IRS in one of three ways (Rev.Proc. 2013-30, § 4.03(2), 2013-36 IRB 173):

• If the corporation has filed all its tax returns as an S corporation (Form 1120S) for the tax years between the date the election is intended to be effective and the current year, the election may be attached to the corporation's current year tax return so long as the return is filed within three years and 75 days of the intended effective date. The return must state at the top "INCLUDES LATE ELECTION FILED PURSUANT TO REV. PROC. 2013-30" or comply with specific instructions included with the Form 1120S instructions. [Rev.Proc. 2013-30, § 4.03(2)(a), supra]

• If the corporation has not filed any income tax returns or information returns for the tax year including the intended effective date and or any year following the intended effective date, the S election may be attached to the Form 1120S for the year including the intended effective date so long as (i) the Form 1120S for the year including the intended effective date is filed within three years and 75 days after the intended effective date, and (ii) all other delinquent Forms 1120S are filed simultaneously and consistently with the required relief. Here again, the Form 1120S must state at the top "INCLUDES LATE ELECTION FILED PURSUANT TO REV. PROC. 2013-30" or comply with specific instructions included with the Form 1120S instructions. [Rev.Proc. 2013-30, § 4.03(2)(b), supra]

• The corporation can submit the S election directly to the IRS Service Center where it files its returns within three years and 75 days after the intended effective date. [Rev.Proc. 2013-30, § 4.03(2)(c), supra]

a) [4:483g] **Exception to three-year-75-day deadlines:** *See ¶ 4:483c*.

4) [4:483h] **IRS response:** Upon receipt of the completed request for relief, the IRS will determine whether the requirements for granting relief have been satisfied and will notify the corporation of its determination. [Rev.Proc. 2013-30, § 4.05, 2013-36 IRB 173]

(3) [4:483.1] **Late-filed shareholder consent:** If a corporation is *unable* to file a shareholder's consent within the requisite time period, the election may nevertheless be treated as timely filed where the IRS grants the corporation an *extension of time* to file *that consent*. [Treas.Reg. § 1.1362-6(b)(3)]

If a corporation *fails* to file shareholder consents within the requisite time period (whether or not following an extension of time), the election may still be treated as timely filed where the failure was "inadvertent" and "steps were taken" to acquire the consents within a reasonable period of time. [IRC § 1362(f)]

[4:483.2 - 4:483.4] ***Reserved.***

(a) [4:483.5] **Failure to provide spousal consent—automatic relief available:** Where an S election (Form 2553, *see ¶ 4:481*) is invalid only because it failed to include the signature of a spouse who was a shareholder *solely pursuant to state community property law* (*see ¶ 2:149.2*), automatic relief is available so long as both spouses reported all items of income, gain, loss, deduction or credit consistent with the S election on all affected federal income tax returns. [Rev.Proc. 2004-35, 2004-1 CB 1029]

1) [4:483.6] **Request to file late shareholder consent:** The *corporation* must file a dated statement that includes the following:

• A representation reading, "This statement is being furnished pursuant to Rev.Proc. 2004-35 for a late filing of shareholder consents for community property spouses of S corporation shareholders in community property states";

• The corporation's name, employer identification number, address, date and state of incorporation, and the intended effective date of the initially-filed S election (Form 2553);

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- Each spouse's name, social security number or employee identification number, tax year end and the total number of shares owned at the date of the intended election;

- A statement that the community property spouses reported all items of income, gain, loss, deduction or credit consistent with the S corporation election on all affected returns; and

- A signed statement from each of the community property spouses reading, "Under penalties of perjury, I, [name of community property spouse], declare that I consent to the election to treat [name of S corporation] to be an S corporation under section 1362(a) of the Internal Revenue Code as of [the date that the S corporation intended to be an S corporation] and to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete." [Rev.Proc. 2004-35, supra; brackets in original]

2) [4:483.7] **IRS response:** The IRS will notify the *shareholder* of its acceptance of the request to file the late shareholder consent or denial of a request that fails to satisfy Rev.Proc. 2004-35. [Rev.Proc. 2004-35, supra]

[4:483.8 - 4:483.9] ***Reserved.***

(4) [4:483.10] **Effect of election delayed or lost in mail:** A document timely deposited in the mail is *deemed filed* with the IRS as of the date of *postmark*. [IRC § 7502(a)(1)]

A taxpayer who has no evidence of postmark (i.e., document not sent by registered or certified mail) may nevertheless offer proof of timely mailing; and proper mailing creates a *rebuttable presumption* of receipt. Where the S election is lost in transit (i.e., taxpayer proves mailing and the IRS proves nonreceipt), the taxpayer bears the risk of nondelivery and, therefore, the S election is *not* effective. [*Smith v. Commr.*, TC Memo 1994-270]

c. [4:483.11] **Disqualification as S corporation; reinstatement following inadvertent termination:** *See ¶ 2:154 ff.*

3. [4:484] **Selection of Corporation's Taxable Year (Non-S Corporations):** If the corporation files its tax returns as an S corporation, it will have to adopt the same taxable year as its shareholders; i.e., normally a calendar year (*see ¶ 2:150*).

[4:485] But if the corporation decides *not* to file under Subchapter S, it can adopt its own taxable year without regard to the taxable year of its shareholders. It may choose either a calendar year or a *fiscal year* ending on the last day of any calendar month. Its choice should be based on the tax and nontax considerations discussed below (*¶ 4:487 ff.*). The only limitation is that it must *regularly* compute its income and keep its books on the basis of the accounting period chosen. [IRC § 441(c); Rev. & Tax.C. § 24631(c)]

a. [4:486] **Timing:** It is often difficult for a new corporation to decide on a fiscal year when it commences operations. And there is no compelling necessity that it do so. The initial selection can be made simply by filing a timely tax return after the close of whatever fiscal year is chosen. (No prior approval of the taxing authorities is required for the initial selection of the taxable year, although any subsequent change requires such approval; *see ¶ 4:497*.) [See Treas.Reg. § 1.441-1; and Rev. & Tax.C. § 24633]

b. [4:487] **Tax considerations affecting choice of fiscal year:** The selection of a fiscal year determines the periods for measuring the corporation's income tax, and for filing federal, state and local tax returns. In general, the selection should be planned to defer reporting income and payment of taxes thereon wherever possible.

(1) [4:488] **Utilizing "short year" return:** The corporation's first taxable year will begin on the date of its incorporation, but will close at the end of whatever fiscal year is chosen. This gives the corporation the power to choose a "stub" or "short period" for its first taxable year that can be utilized to *defer income* (and payment of taxes thereon); *see ¶ 2:114*.

For example, suppose a corporation is incorporated on June 15, and chooses a fiscal year ending August 31. Its initial tax year (or "stub") will run from June 15 to August 31 (just 2 1/2 months). Thereafter, of course, its annual taxable year will be September 1 to August 31.

(a) [4:489] **Start-up losses:** Such a "stub" or "short year" return makes sense where the corporation has incurred initial operating losses, but is becoming profitable. By cutting off its tax year at a point where it no longer has any losses, the corporation can defer reporting any income. All of its profits will be reported in the following taxable year, and taxes thereon deferred accordingly.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) [4:490] **Seasonal income:** Similarly, a "stub" or "short year" can be utilized where the corporation's business is highly seasonal. A fiscal year can be chosen which ends just before its seasonal high income is received. This will enable it to defer reporting the income and paying the taxes thereon for a full year (and the same with each succeeding year).

(2) [4:491] **Delaying tax on distributions to officers and shareholders:** Since the individual shareholders and officers of the corporation will normally be on a calendar-year basis for tax purposes, the corporation may want to adopt a fiscal year that facilitates deferral of tax on income distributed to such officers and shareholders.

(a) [4:492] **Year-end bonuses:** For example, with a closely-held corporation, where it is anticipated that year-end bonuses will be distributed to the officer-shareholders for their services, it may be desirable to adopt a fiscal year ending on January 31. This enables the corporation to take a current deduction for the year-end bonus payments, and the officer-shareholders won't have to pay taxes thereon until after the end of the calendar year (although applicable taxes are normally withheld at the time of distribution).

(b) [4:493] **Dividends:** Similarly, a January 31 year-end makes sense for dividend distributions. Although there won't be any deductions for the corporation, it will defer the shareholders' tax liability on the dividends until after the close of the calendar year (but the shareholders may have to pay estimated taxes on the dividends received).

(c) [4:494] **Corporation on accrual basis:** Subject to important limitations (*see ¶ 2:118*), a corporation on the *accrual* basis can deduct salaries, interest, or other expenses due its officer-shareholders, even if such payments are not actually made until the following calendar year. [IRC § 267(a)(2)]

Thus, it may be desirable to have the corporation adopt a fiscal year ending *October 31*. It can deduct salaries and bonuses (or other expenses or interest) due its officer-shareholders and defer payment until January 2 of the following year. The officer-shareholders (cash-basis taxpayers) are not deemed to have income until *receipt* thereof; thus their taxes are deferred until after the close of the calendar year in which they receive the payment (*see ¶ 2:116*).

1) [4:494.1] **Caution re deferred compensation:** All arrangements for deferred compensation paid to shareholders, officers, etc. should be reviewed for compliance with IRC § 409A. Attorneys who are not familiar with this complex provision should consult with a tax specialist. [See R. Olshan and E. Schohn, *Section 409A Handbook* (Bloomberg BNA, 2nd ed. 2016)]

c. [4:495] **Nontax considerations affecting choice of fiscal year:** The selection of a fiscal year also affects the timing of the annual report to shareholders (due within 120 days after close of fiscal year; see Corps.C. § 1501(a), *¶ 6:542*). This in turn affects the scheduling of the annual shareholders' meeting (*see ¶ 6:48*).

➪ [4:496] ***PRACTICE POINTER:*** With a closely-held corporation, these factors are usually far less important than the tax considerations discussed above (*¶ 4:487 ff.*). But with publicly-held corporations, a fiscal year is often chosen which presents the corporation's operating results in the best possible light for its report to the shareholders; e.g., closing after seasonal high income is received.

d. [4:497] **Change of taxable year:** Before it files its first tax returns, the corporation can change its mind as often as it chooses regarding a fiscal year. Even if the board of directors selected a fiscal year at the organizational meeting, that is not binding; the board can later adopt an earlier or later month-end within the corporation's first year of operations.

However, after the first tax returns have been filed, any subsequent change of the corporation's fiscal year requires *prior approval* of the Internal Revenue Service and California Franchise Tax Board. Form 1128 ("Application to Adopt, change, or Retain a Tax Year") is used. [IRC § 442; Rev. & Tax.C. § 24633; see Rev.Proc. 2002-39, 2002-1 CB 1046; Rev.Proc. 2006-45, 2006-2 CB 851; Rev.Proc. 2006-46, 2006-2 CB 859; *and ¶ 2:150*]

4. [4:498] **Other Tax Matters:** In addition to the foregoing, there are various other federal and state tax matters to be attended to by a new corporation:

a. [4:499] **Federal employer identification number:** A new taxpaying entity must obtain a federal employer identification number. The identification number will be required on the entity's tax returns, and is usually required by banks in opening the corporate bank accounts and for deposits of taxes withheld from employee wages. [See IRC § 6109(a)]

The identification number may be applied for and obtained online at the IRS website (*www.irs.gov*). Or it can be obtained by filling out a Form SS-4 (available on the IRS website) and mailing it to:

Internal Revenue Service
Attention: EIN Operation

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cincinnati, Ohio 45999

The form can also be faxed to the IRS at 855-641-6935.

b. [4:500] **Estimated tax payments:** Every corporation owing $500 or more in federal income taxes must make quarterly payments of estimated tax. Failure to do so may result in penalties. [IRC § 6655]

c. [4:501] **Choosing accounting methods for tax purposes:** In addition to selecting a taxable year (¶ *4:484*), the corporation may have a choice as to the methods of *depreciation* it will utilize (e.g., accelerated, straight-line, etc.). [See IRC § 168]

The corporation may also choose whether to use the *cash or accrual* method of accounting. Ordinarily, C corporations cannot use the cash method, but exceptions are permitted for:

- Farming businesses;
- Qualified personal service corporations (i.e., corporations substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting); and
- Corporations having average annual gross receipts not exceeding $30 million for the three-taxable-year period ending with the preceding taxable year (adjusted for inflation). [IRC § 448; Treas.Reg. § 1.448-2(b)(2)(iii)(B)(2); Rev.Proc. 2023-34, 2023-48 IRB 1287]

These accounting decisions need not be made in advance. They are made on the corporation's initial tax return.

(1) [4:501.1] **Caution:** The IRS released Revenue Procedure 2022-09, which updates the guidance on changing the automatic accounting method by providing taxpayers procedures to comply with the final IRC § 448 regulations. [See Treas.Reg. § 1.448-2(b)(2)(iii)(B)(2); Rev.Proc. 2022-09]

d. [4:502] **Sales and use taxes:** Every taxpayer engaged in retail sales of tangible personal property is required to obtain a seller's permit from the State Board of Equalization. [See Rev. & Tax.C. § 6066]

A corporation so engaged will also be required to collect applicable sales taxes on its retail sales transactions; and to pay or prepay the taxes collected on a monthly or quarterly basis, depending on the amounts involved. [See Rev. & Tax.C. §§ 6451, 6471]

Holding a valid seller's permit enables the corporation to purchase inventory for resale without paying a sales tax, by showing suppliers its resale certificate number.

➪ [4:503] ***PRACTICE POINTER:*** For this reason, even if the corporation does *not* intend to sell tangible personal property at retail (e.g., it plans to manufacture or distribute wholesale), it should obtain a seller's permit. This will enable it to purchase whatever materials and supplies it needs to produce the items it sells without having to pay sales tax to its own suppliers.

e. [4:504] **Employment taxes:** The corporation will have to withhold federal and state income taxes from wages paid to its employees, together with a variety of other taxes: federal social security (FICA), federal unemployment (FUTA), state unemployment and disability, etc. [See Unemp.Ins.C. § 1086—registration with California Employment Development Department required within 15 days of hiring first employee]

Payroll taxes withheld from employee wages must be deposited with an authorized bank, and quarterly or other returns filed with the appropriate federal and state agencies. Normally these matters are handled by corporate personnel or accountants, but the attorney should make sure that the clients are aware of these taxes.

f. [4:505] **Property taxes:** A corporation owning *personal* property costing $100,000 or more may have to file a property statement with the county assessor. [Rev. & Tax.C. § 441]

The corporation will have to pay property taxes on any *real* property held in its name. (And any real property contributed to the corporation upon its formation may be subject to reassessment; *see* ¶ *2:177.6 ff.*)

Again, these matters are normally handled by corporate personnel, but the attorney should make sure that the clients are aware of them.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

➪ [4:505.1] ***PRACTICE POINTER:*** For information on real and personal property taxes, consult, or refer your clients to, the assessor's website for the county in which the corporation's property is located. A list of the county assessors, with hyperlinks to their websites, can be found at *www.boe.ca.gov/proptaxes/countycontacts.htm*.

5. [4:506] **Business Licenses and Permits:** Generally, every new business is required to obtain some sort of license or permit. Most cities and counties have business licenses, the fees varying with the type of business activity; some cities charge according to the gross receipts of the business. Corporate personnel should check with the city clerk of each city in which the corporation plans to engage in business.

In addition, there may be state licensing requirements to consider: e.g., liquor licenses, contractor's licenses, etc. Usually the clients will know what the licensing requirements are in the field in which they intend to operate.

➪ [4:507] ***PRACTICE POINTER:*** Where the corporation is taking over an existing business, the licenses and permits granted to the prior owner (e.g., private owner or partnership) generally do *not* carry over to the corporation. The corporation will have to apply for and obtain licenses and permits in its own name. Thus, to whatever extent there are special qualifications or requirements to obtain a license, the corporation will have to be able to comply in its own right (usually by showing the qualifications of its managing employees or officers).

6. [4:508] **Insurance Matters:** Counsel should be sure to discuss with the corporate officers the nature and extent of insurance coverage they plan to obtain. They should be encouraged to review their business plans with several different insurance agents or brokers, to obtain competitive bids on the insurance premiums and to get several viewpoints on the most efficient coverage.

a. [4:509] **Workers' compensation coverage:** Every employer is required to maintain workers' compensation insurance, either through a private insurance carrier or the State Compensation Insurance Fund (unless permission to self-insure is obtained in advance from the Director of Industrial Relations—a rare case). [Lab.C. § 3700]

b. [4:510] **Liability insurance:** Counsel should review whatever liability insurance is proposed for the corporation, to make sure that the coverage is complete and that the amounts are realistic. Some policies are offered with sizeable deductibles to lower the premium cost. Counsel should make sure the clients understand the costs of litigation in evaluating whether such deductibles are worthwhile.

7. [4:511] **Compliance With Bulk Sales Statutes:** Where the assets of a going business are being transferred to a corporation, for either cash or stock, the bulk sales statutes (Comm'l C. § 6101 et seq.) may apply. These statutes are designed to put the seller's creditors on notice of the proposed sale and to give them opportunity to assert their claims so as to obtain payment or provision for payment before the sale takes place. [See *Gifford v. J & A Holdings* (1997) 54 CA4th 996, 1003, 63 CR2d 253, 258; *Monastra v. Konica Business Machines, U.S.A., Inc.* (1996) 43 CA4th 1628, 1636-1637, 51 CR2d 528, 533-534—compliance with bulk sales statutes does not insulate sale from liability under fraudulent transfer laws (now voidable transaction laws, Civ.C. § 3439 et seq.)]

➪ [4:511.1] ***PRACTICE POINTER:*** As a practical matter, it is generally *not* necessary to comply with the bulk sales law in organizing a corporation. This is because the organizers generally intend that the transferee corporation *will* be liable to all of the transferred business' existing creditors. Therefore, noncompliance exposes the corporation to no greater burden than it has already assumed or agreed to pay (*see* ¶ *5:437*).

Moreover, the transfer may be excluded from the bulk sales law if the transferee corporation timely records and publishes notice of its assumption of the transferor's debts (¶ *4:515*).

Thus, compliance is important only in the relatively uncommon situation where the new corporation is acquiring assets of a going business but *not* assuming its liabilities (and even then, the transfer may fall within one of the exemptions based on the transferred assets' value; ¶ *4:515*).

a. [4:512] **Which businesses:** Businesses whose principal purpose is the *sale of inventory from stock* (including those who *manufacture* what they sell) and restaurants are subject to the statutory requirements below (¶ *4:516 ff.*) … *provided* the seller (or, if the seller is located outside the U.S., the seller's principal executive office) is located in California on the date of the bulk sale agreement. [Comm'l C. § 6103(a)(1) & (2)]

(1) [4:513] But *service* businesses, or businesses in which the sale of merchandise is only incidental, are not subject to the bulk sales requirements. Examples: travel agencies, advertising agencies, newspapers, television broadcasters, etc.

b. [4:514] **Which sales:** Sales of *more than half* of a covered business' inventory and equipment, not in the ordinary course of business, as measured by value on the date of the bulk sale agreement are subject to the statutory requirements below (¶ *4:516 ff.*). [Comm'l C. § 6102(a)(3)]

(“Sale” is defined as the passing of title for a price; see Comm'l C. § 2106(1).)

(1) [4:515] **Exemptions:** The following exemptions may apply to transfers in capitalization of a corporation:

- A sale of assets valued under $10,000 (net of liens and security interests). [Comm'l C. § 6103(c)(12)(i)]
- A sale of assets valued over $5,000,000 on the date of the bulk sale agreement. [Comm'l C. § 6103(c)(12)(ii)]
- A sale to a buyer whose principal place of business is in the U.S. and who timely obtains a list of the seller's claimants or conducts a reasonable inquiry to discover their identity, assumes the debts owed to known claimants, is not insolvent after the assumption, and timely records and publishes notice of the assumption. [Comm'l C. § 6103(c)(9)]
- A sale to a buyer whose principal place of business is in the U.S. and who assumes the seller's presale debts, is not insolvent after the assumption, and timely records and publishes notice of the assumption. [Comm'l C. § 6103(c)(10)]
- A sale to a new organization whose principal place of business is in the U.S. and is organized to take over and continue the seller's business … provided the buyer assumes the seller's presale debts, timely records and publishes notice of the assumption, and the seller receives nothing from the sale except an interest in the new organization subordinate to the assumed claims. [Comm'l C. § 6103(c)(11)]

c. [4:516] **Statutory notice requirement:** If the business and sale fall within the statute, the buyer-corporation (not the seller) is under a statutory duty to give notice to the seller's creditors. [Comm'l C. § 6104]

(The buyer must also obtain a list of all business names and addresses used by the seller during the previous three years and, if applicable, provide for payment of the seller's creditors (*see* ¶ *4:520*); Comm'l C. § 6104.)

(1) [4:517] **Contents:** The notice must state that a bulk sale is about to take place; the names and business addresses of the proposed seller and buyer; the description and location of the property being sold; the place and anticipated date of the sale; whether the sale price is $2,000,000 or less (cash or notes) and if so, the name and address of the person with whom creditors' claims should be filed, and the last date for filing such claims (which shall be the business day before the anticipated sale date). [Comm'l C. §§ 6105(a), 6106.2(f)]

- ***FORM:*** Notice of Bulk Sale, *see Form 4:F*.

(2) [4:518] **Recordation and publication:** The notice must be recorded in the county recorder's office of the county where the property is located, *and* must be published at least once in a newspaper of general circulation in the district where the property is located (and, if different, where the seller is located). All must be completed at least *12 business days* before the sale date set forth in the notice. [Comm'l C. § 6105(b)(1) & (2); see *Gifford v. J & A Holdings* (1997) 54 CA4th 996, 1005-1006, 63 CR2d 253, 259-260]

(a) [4:518.1] **Effect of sale postponement upon notice requirement:** As long as the creditors were given the requisite 12 business days' notice of sale (¶ *4:518*), a postponement of the sale does not prejudice their rights, and hence a new notice is *not* required. [*Gifford v. J & A Holdings* (1997) 54 CA4th 996, 1006, 63 CR2d 253, 260]

But where the sale date set forth in the notice is *less* than 12 business days after publication/recordation, postponing the sale does *not* cure the defective notice. Creditors who fail to submit their claims before the noticed date and who have no knowledge of the postponement might very well assume that submitting the claim after the noticed date is futile. In these circumstances, postponing the sale does the creditors no good. [*Gifford v. J & A Holdings*, supra]

(3) [4:519] **Mailed notice to tax collector:** In addition, the notice must be sent by certified or registered mail to the tax collector of the county where the property is located at least 12 business days before the sale date. If delivered between January 1 and May 7, the notice must be accompanied by a completed business property statement (Rev. & Tax.C. § 441). [Comm'l C. § 6105(b)(3)]

d. [4:520] **Provision for payment of seller's creditors:** If the assets are being transferred for stock or securities, no provision for payment of creditors' claims is required. (A creditor's remedy once title has passed to the buyer is a damages action in the amount of their claim; *see* ¶ *4:521*.) However, if the assets are being sold for cash or debt instruments, and the price

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

is $2,000,000 or less, provision for *payment* of the seller's creditors is required. The notice itself must designate someone (usually an escrow agent) to receive the creditors' claims before the sale date. Then, the buyer or escrow agent is under a duty to apply whatever cash is due the seller to payment of these claims. (Special rules apply where the claims are disputed by the seller, or exceed the available cash.) [See Comm'l C. §§ 6106.2, 6106.4]

e. [4:521] **Effect of noncompliance with statutory requirements:** Buyers who fail to provide the requisite notice to creditors, or to make provision for their payment where required, are liable to each creditor for damages in the amount of the claim (reduced by any amount the creditor would *not* have recovered had the buyer complied). [Comm'l C. § 6107(a)]

(1) [4:522] **"Good faith" exception:** However, buyers are not liable to creditors for failure to provide the requisite notice, etc. if they made a "good faith" and "commercially reasonable effort" to comply or to structure the sale to satisfy one of the authorized exemptions (¶ 4:515). [Comm'l C. § 6107(c)]

(2) [4:523] **No other liability:** A noncomplying sale is *neither void nor voidable*. It does not impair the buyer's title to the assets or create any liability other than as provided in the bulk sales law. Hence, a creditor's damages action is apparently the only avenue of recovery available once title to the property has passed to the buyer. [Comm'l C. § 6107(h)]

(a) [4:524] **Compare—prior law:** Before 1991, a noncomplying transfer was deemed "fraudulent and void" as against the transferor's creditors. The result was that creditors could levy attachment and execution against the assets transferred, as if they still belonged to the transferor. [See Comm'l C. § 6105 (repealed)]

(Presumably, attachment and execution are still available remedies so long as effected *before* title is transferred.)

(3) [4:525] **Which creditors:** Actions seeking damages may *not* be brought by or on behalf of claimants with contingent or unliquidated claims. [Comm'l C. § 6107(g)]

(4) [4:526] **Buyer's reimbursement right:** Buyers may seek reimbursement from sellers for amounts paid to creditors in partial or total satisfaction of their liability … *unless otherwise agreed*. [Comm'l C. § 6107(j)]

8. [4:527] **Qualifying to Do Business in Other States:** A corporation transacting business in states other than California may be required to formally *qualify* to do business in those states. The qualification threshold (i.e., the amount of business that can be transacted without qualification; see, e.g., Corps.C. § 191), the penalties for failure to qualify, and the procedures for qualification vary from state to state. Usually, qualification requires the filing of specified documents, together with a copy of the articles of incorporation, a good standing certificate from the Secretary of State, and payment of initial and annual fees.

➪ [4:528] ***PRACTICE POINTER:*** The decision whether to qualify should be made cautiously. Once a corporation qualifies in another state, it may be required to maintain a business address within that state, appoint a local agent for service of process, file annual reports (including *tax returns*), etc. On the other hand, failure to qualify may result in penalty assessments (see, e.g., Corps.C. § 2203). Thus, counsel should carefully check the qualification requirements of any states where the corporation intends to do business.

a. [4:529] **Formalities:** When submitting documents in other states, be sure to check the appropriate office's filing procedures. Some offices may impose rather unusual requirements ("blue backings," formatting criteria, etc.) that are not set forth in the statutes.

b. [4:530] **Professional services:** It may be efficient to utilize a commercial service to assist in qualifying the corporation in other states. For an annual fee, these companies often act as the corporation's agent for service of process (*see ¶ 3:417*) and apprise attorneys of local law developments that may affect the corporation. For the names of some of these companies, do an online search for "registered agents" or "statutory agents," or ask other attorneys for a reference.

9. [4:531] **Corporate Transparency Act:** Starting January 1, 2024, under the federal Corporate Transparency Act (CTA), corporations, limited liability companies, and other similar entities formed or registered to do business in the United States ("reporting companies," ¶ 4:532) must register "beneficial ownership information" (*¶ 4:534*) with the United States Treasury Department's Financial Crimes Enforcement Network (FinCEN). Some exemptions apply (*see* ¶ 4:533). The reporting requirements are intended to help combat financial crimes like money laundering. Failure to comply may result in substantial criminal and civil penalties. [See 31 USC § 5336(h)]

a. [4:532] **Reporting companies:** Domestic reporting companies are corporations, limited liability companies, and other entities formed by filing a document with a secretary of state or similar office under the law of a state or Indian tribe. Foreign reporting companies are corporations, limited liability companies, and other entities formed in a foreign country and registered

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

to do business in the U.S. or any tribal jurisdiction by submitting a document with a secretary of state or similar office under the law of a U.S. state or Indian tribe. [31 USC § 5336(a)(11); 31 CFR § 1010.380(c)]

(1) [4:533] **Exemptions:** There are 23 specific types of entities that are exempt from the reporting requirements, including, among others, governmental authorities, banks, credit unions, securities brokers/dealers, investment companies, insurance companies, accounting firms, tax exempt entities, and "large operating companies" (defined as companies with more than 20 full-time U.S. employees that has an operating presence at a physical U.S. address and filed a tax return for the previous year showing over $5M in gross receipts/sales). [See 31 CFR § 1010.380(c)(2)]

b. [4:534] **Beneficial ownership information:** Reporting companies must report (and update, as needed) "beneficial ownership information" (BOI) identifying the individuals who (1) directly or indirectly exercise "substantial control" over the reporting company, or (2) own or control 25 percent or more of the reporting company's "ownership interests." [31 USC § 5336(b); 31 CFR § 1010.380(a), (b), (d)]

c. Required reports and timeframes

(1) [4:535] **Initial report:** The initial report must be filed within the following timeframes (31 CFR § 1010.380(a)(1)):

- Reporting companies formed or registered before January 1, 2024 must register with FinCEN on or before January 1, 2025.

- Reporting companies formed in 2024 must register with FinCEN within 90 calendar days of receiving notice of the company's formation or registration.

- Reporting companies formed in 2025 or later must register within 30 calendar days of receiving notice of the company's formation or registration.

(2) [5:536] **Updated reports:** Updated reports must be filed for specified changes and events. [See 31 CFR § 1010.380(a)(2)]

(3) [5:537] **Electronic reporting:** Reporting companies are required to submit their reports electronically through FinCEN's secure BOI e-filing website (https://boiefiling.fincen.gov).

d. [5:538] **Access to reported information:** The CTA authorizes FinCEN to disclose the information to the following types of entities for limited purposes:

- U.S. Federal agencies for use in national security, intelligence, or law enforcement activity;

- State, local, and Tribal law enforcement agencies for use in criminal or civil investigations (with court authorization);

- Foreign law enforcement agencies, judges, prosecutors, central authorities, and competent authorities, under specified circumstances;

- Financial institutions and regulatory agencies to facilitate compliance with customer due diligence requirements; and

- Treasury Department officers and employees whose job duties require BOI inspection/disclosure. [See 31 USC § 5336(c); 31 CFR § 1010.955(b)-(d)]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 4:A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki ‘Vicki’ Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

Forms

[Form 4:A] Articles of Incorporation (“Short Form”)

ARTICLES OF INCORPORATION

OF

____

I

The name of this corporation is ___________.

II

The purpose of this corporation is to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law of California other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code.

III

The initial street address of the corporation is: _____ ___________

[If the corporation's initial mailing address is different from its initial street address:]

The initial mailing address of the corporation is: _____ ___________

IV

The name and street address in the State of California of this corporation's initial agent for service of process is: _____ ___________

V

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

This corporation is authorized to issue only one class of shares of stock; and the total number of shares which this corporation is authorized to issue is ________________ ___________.

DATED: ___________

____

(Signature of Incorporator)

____

(Typed name of Incorporator)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 4:A.1

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

Forms

[Form 4:A.1] Optional Articles Provisions

[FORM 4:A.1a]

Authorizing Voting and Nonvoting Common Stock

IV

This corporation is authorized to issue two classes of shares, designated respectively "Class A Common Stock" and "Class B Common Stock." ___ shares of Class A Common Stock may be issued. ___ shares of Class B Common Stock may be issued. The Class A Common Stock has exclusive voting rights on all matters requiring a vote of the shareholders, including election of directors, and the Class B Common Stock has no voting rights, except as otherwise provided by law.

[FORM 4:A.1b]

Authorizing Common and Preferred Stock with Attributes Specified

IV

This corporation is authorized to issue two classes of shares, designated respectively "Common Stock" and "Preferred Stock." _____ shares of Common Stock may be issued. _____ shares of Preferred Stock may be issued. The Common Stock has full voting rights. The Preferred Stock has only those voting rights as are provided by law *(and as set forth below)*. The rights, preferences, privileges and restrictions granted to or imposed upon the two classes of shares are as follows: *[See Forms 4:A.1c ff.]*

[FORM 4:A.1c]

Establishing Dividend Preferences

(Noncumulative)

(a) The Preferred Stock is entitled to receive annual dividends on a noncumulative basis at the rate of $________ per share, as and when declared by the board of directors *[out of][*or *if mandatory: and the board is obligated to declare and distribute to the extent of]* funds legally available therefor. No dividends or other distributions may be made on the Common Stock during any fiscal year of the corporation until dividends on the Preferred Stock in the total amount of $________ per share during that fiscal year have been declared and paid or set apart for payment. *(If discretionary: No right shall accrue to the Preferred*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Stock if the corporation fails to declare or pay any dividends thereon in any fiscal year(s), whether or not the corporation had sufficient funds in such year(s) lawfully to pay all or part of such dividends.)

(Cumulative)

(a) The Preferred Stock is entitled to receive dividends on a cumulative basis at the annual rate of $________ per share *(if non-participating: and no more,)* payable on the _____ day of the months of *[_____ and _____,]* or *[_____, _____, _____ and _____,]* when and as declared by the board of directors *[out of]* or *if mandatory: and the board shall be obligated to declare and distribute same to the extent of]* funds legally available therefor. Such dividends accrue from the date of issuance, whether or not earned. They have preference over the Common Stock, so that no dividend or other distribution may be made on the Common Stock until cumulative dividends on the Preferred Stock have been paid (or set apart for payment) for all past dividend periods and for the current period.

[FORM 4:A.1d]

Establishing Participation Rights

(Nonparticipating)

The Preferred Stock is not entitled to any additional dividends beyond the *[noncumulative]* or *[cumulative]* dividends specified above. After the *[noncumulative]* or *[cumulative]* dividends on the Preferred Stock have been paid or set apart, any additional dividends declared by the board shall be declared solely on the Common Stock. The Preferred Stock may not participate in such dividends.

(Participating)

The Preferred Stock is entitled to participate in any additional dividends declared by the board of directors out of funds legally available therefor, after payment of their *[cumulative]* or *[noncumulative]* dividends has been made or set apart *(and after* $________ *per share is declared and paid or set apart on the outstanding Common Stock)*. Thereafter, any such additional dividends must be declared in equal amounts per share on all outstanding Preferred and Common Stock, considered for this purpose as a single class.

[FORM 4:A.1e]

Establishing Voting Switch on Dividend Default

Except as otherwise provided by these Articles or by law, the Common Stock has exclusive voting rights and powers, including the exclusive right to notice of shareholders' meetings. However, if the dividend payments on the Preferred Stock *(and/or series)* are in default for _____*(eight)* or more _____*(quarterly)* periods *(whether or not consecutive)*, the Preferred Stock must (1) be given notice of shareholders' meetings; and (2) may immediately elect, as a class, the smallest number of directors constituting a majority of the board. The Common Stock will retain only the right to elect, as a class, the remaining director(s).

These voting rights will continue until all dividends accrued on the Preferred Stock *(and/or series)* have been paid or set apart for payment. At such time, the right of the Preferred Stock to elect directors and to receive notice of shareholders' meetings shall cease, and the exclusive right to elect directors and to receive notice of shareholders' meetings shall revert to the Common Stock. However, if further defaults in the payment of dividends on the Preferred Stock *(and/or series)* occur, the voting rights granted to the Preferred Stock under this article shall be renewed.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

If the Preferred Stock *(and/or series)* acquires voting rights under this article, a special meeting of the shareholders for the election of directors (as described above) may be called by any officer or director of the corporation, in accordance with the bylaws. In addition, such a meeting must be called immediately by the Secretary upon written request of the record holders of at least ____% *(e.g., 5%)* of the outstanding Preferred Stock *(or series)*. For this purpose, any holder or officer of an entity holder of Preferred Stock shall be granted access on demand to the corporation's stock records and shareholder lists.

At any such special meeting (or at any annual meeting held while the Preferred Stock has the voting power to elect a majority of directors), the holders of a majority of the then-outstanding shares of said Preferred Stock *(or series)*, present in person or by proxy, shall constitute a quorum for the election of directors. The terms of office of all directors of the corporation at the time of such meeting shall immediately terminate upon the election by the Preferred Stock at such meeting of the number of directors it is entitled to elect under this article. If the Common Stock fails to elect the number of directors to which it is entitled, additional directors may be appointed by the directors elected by the Preferred Stock.

The directors elected or appointed by the Preferred Stock, together with the directors elected at such meeting by the Common Stock (if any), shall constitute the duly elected Board of Directors of the corporation. When the Preferred Stock is no longer entitled to voting rights under this article, the terms of office of all directors shall immediately terminate upon the election of their successors by the Common Stock.

[FORM 4:A.1f]

Establishing Liquidation Preferences

(b) Upon the voluntary or involuntary liquidation, winding up or dissolution of the corporation, the Preferred Stock is entitled to receive out of the assets available for distribution to shareholders, in preference to any payment on the Common Stock, an amount equal to $________ per share; plus a premium of $________ per share if the dissolution is voluntary; plus any *[accrued and unpaid cumulative]* or *[previously declared noncumulative]* dividends, *[if nonparticipating: and no more. If the assets of the corporation are insufficient to pay the full liquidation preference to the Preferred Stock, the entire remaining assets shall be paid to the Preferred Stock, and the Common Stock shall receive nothing. After the full liquidation preference has been paid or set apart for the Preferred Stock, the remaining assets shall be paid to the Common Stock.] or [if participating: If the assets of the corporation are insufficient to pay the full liquidation preference to the Preferred Stock, the entire remaining assets shall be paid to the Preferred Stock, and the Common Stock shall receive nothing. After the full liquidation preference has been paid or set apart for the Preferred Stock, the remaining assets shall be paid in equal amounts on all outstanding shares of Preferred and Common Stock, considered for this purpose as a single class.]*

[FORM 4:A.1g]

Granting Redemption Rights

(At option of corporation)

(c) The corporation may from time to time redeem all or part of the outstanding Preferred Stock by paying in cash $________ per share, plus all accrued and unpaid dividends on each redeemed share up to and including the date of redemption (the "redemption price"). If less than all of the outstanding preferred shares are to be redeemed, the redemption shall be *(by lot)* or *(on a pro-rata basis as designated by the board of directors)* or *(in a manner approved by the board of directors)*. However, no partial redemption shall be made unless all accrued dividends on all outstanding Preferred Stock for all past periods and for

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

the current period have been paid or set apart for payment (except that unaccrued dividends for the current period may not be paid or set apart for the shares being redeemed).

The corporation shall give notice of any redemption to each record holder of Preferred Stock to be redeemed, by first-class mail (postage prepaid) at the shareholder's address as shown on the corporation's records. Such notice must state: the class or series of shares to be redeemed; whether all or less than all of the outstanding shares of such class or series are to be redeemed; the redemption date; the redemption price; and the place of payment of the redemption price.

On or before the redemption date, each holder of shares to be redeemed shall, *(unless conversion rights have previously been exercised as to such shares—as provided in these Articles,)* surrender the share certificate to the corporation at the place designated for payment in the redemption notice, and shall then be entitled to be paid the redemption price. If fewer than all of the shares represented by a surrendered certificate are redeemed, a new certificate shall be issued representing the unredeemed shares. Whether or not the certificates representing the redeemed shares are surrendered, all rights accorded such shares (including accrual of dividends) shall terminate, except for the right of the shareholders to receive the redemption price without interest upon surrender of the certificate (provided the redemption notice was given in the manner required by this article, and the redemption price is available for payment on the redemption date).

(At option of shareholder)

(c) At any time after *(e.g., the corporation's retained earnings exceed* $________*)* any holder of the outstanding Preferred Stock *(series)* may from time to time require the corporation to redeem all or part of his or her shares for cash, in the amount of $________ per share, plus all accrued and unpaid dividends on each redeemed share up to and including the date of redemption (the “redemption price”).

Such shareholder must give written notice to the corporation by first-class mail (postage prepaid). Such notice must state: the occurrence of the event giving rise to the redemption right; the class or series of the shares to be redeemed; the number of shares to be redeemed; whether all or fewer than all of the shares of such class *(and/or series)* held by the shareholder are to be redeemed; the redemption date; and the name and address for payment of the redemption price.

No shares may be redeemed unless all accrued dividends for all past periods, and dividends to accrue for the present period, have been paid or set apart for payment on all outstanding Preferred Stock. However, unaccrued dividends for the current period may not be paid or set apart for the shares being redeemed.

(At option of majority of class)

(c) In the event that *(e.g., the corporation's retained earnings exceed* $________*)* a majority of the holders of the Preferred Stock may require the corporation to redeem all or a designated portion of such shares *(and/or class)* for cash in the amount of $________ per share, plus all accrued and unpaid dividends on each redeemed share up to and including the date of redemption (the “redemption price”). Such action may be taken by a vote at a meeting of the holders of such shares, or by their written consent. Such shareholder action must specify the occurrence of the event giving rise to the redemption right; the class *(and/or series)* to be redeemed; whether all or less than all the outstanding shares of such class *(and/or series)* are to be redeemed; the method of selecting those shares to be redeemed (if less than all the outstanding shares of the class *(and/or series)* are to be redeemed); the number of shares to be redeemed; the redemption date; and the place of payment of the redemption price.

At least _____ days before the redemption date, the affected shareholders must give the corporation signed written notice of such action by first-class mail (postage prepaid). Such notice must set forth the matters described in the above paragraph, and state the number of shares voting in favor of, or consenting to, such redemption.

Within _____ days after receiving such notice, the corporation shall give a written redemption notice to each record holder of the shares to be redeemed, by first-class mail (postage prepaid). Such notice must set forth all of the matters in the shareholder's written notice, and state: that the redemption has been requested by a majority of the outstanding shares of the class *(and/or series)* to be redeemed; the number of shares of such class *(and/or series)* outstanding; the number of shares voting in favor of, or consenting in writing to, such redemption; and the redemption price.

[FORM 4:A.1h]

Granting Conversion Rights

(Shares not redeemable)

(d) Holders of the Preferred Stock shall be entitled to convert their shares to shares of Common Stock *(at such time as _____,)* or *(at any time,)* on the basis of *(e.g., share for share)*.

(Shares redeemable)

(d) At any time up to and including _____ days before the date fixed for redemption of redeemable shares in a notice of redemption (as provided above), holders of shares being redeemed pursuant to these articles who endorse the share certificates and deliver them (together with a written notice of their intent to convert) to the corporation at its principal office, shall be entitled to receive _____ shares of Common Stock for each share being converted. Such redemption is subject to the following adjustments, terms and conditions:

(1) If the number of outstanding shares of Common Stock has been increased or decreased since the initial issuance of the Preferred Stock (or series) having conversion rights (by reason of any split, stock dividend, merger, consolidation or other capital change or reorganization affecting the number of outstanding shares of Common Stock), the number of shares of Common Stock to be issued on conversion to the holders of Preferred Stock shall equitably be adjusted by appropriate amendment of this article. The purpose of such adjustment is to preserve fairly and equitably (as far as reasonably possible) the original conversion rights of the shares being converted. No redemption notice pursuant to this article shall be given until an amendment to the articles required to effect this adjustment has been made.

(2) Shares converted under this article shall not be reissued. The corporation shall at all times reserve and keep available a sufficient number of authorized but unissued common shares, and shall obtain and keep in effect any required permits, to enable it to issue and deliver all common shares required to implement the conversion rights granted herein.

(3) No fractional shares shall be issued upon conversion, but the corporation shall pay cash for any fractional shares of Common Stock to which shareholders may be entitled, at the fair value of such shares at the time of conversion. Such fair value shall be determined by the board of directors.

[FORM 4:A.1i]

Authorizing Common and Preferred Stock “In Blank” (Board to Fix Attributes)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) This corporation is authorized to issue two classes of shares, designated respectively “Common Stock” and “Preferred Stock.” _____ shares of Common Stock may be issued. _____ shares of Preferred Stock may be issued.

(b) The board of directors may divide the Preferred Stock into any number of series. The board shall fix the designation and number of shares of each such series. The board may determine and alter the rights, preferences, privileges and restrictions granted to and imposed upon any wholly unissued series of the Preferred Stock. The board of directors (within the limits and restrictions of any resolution adopted by it, originally fixing the number of shares of any series) may increase or decrease the number of shares of any such series after the issue of shares of that series, but not below the number of then outstanding shares of such series.

[FORM 4:A.1j]

Granting Preemptive Rights

(Full preemptive rights)

V

Each holder of *(e.g., Common Stock)* has full preemptive or preferential rights, as defined by law, to subscribe for or purchase that holder's proportional part of any such shares that may be issued at any time by this corporation. This article can be amended only by the vote or written consent of the holders of at least 66 2/3rds of the outstanding *(specify class)*.

V

(Limited preemptive rights)

(Add at end of first sentence above: for cash) These rights shall not apply to shares issued for noncash consideration, or pursuant to any present or future stock option plan, stock purchase, stock bonus, savings investment, or other stock incentive plan approved by the shareholders of the corporation for the benefit of the employees of the corporation or any of its subsidiaries.

[FORM 4:A.1k]

Establishing Fixed Number of Directors

The number of directors of this corporation is _____. The names and addresses of the initial directors are as follows:

Name	**Address**
____________	____________
____________	____________
____________	____________

[FORM 4:A.1*l*]

Establishing Variable Number of Directors

VI

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

The number of directors of the corporation shall be not less than _____ nor more than _____*(not more than twice the minimum number minus one)*. The board of directors or shareholders shall fix the exact number of directors in the manner provided in the bylaws, within the limits specified above.

[FORM 4:A.1m]

Requiring Super-Majority Vote of Directors

V

[Not less than ____% of the authorized number of directors must approve all corporate actions requiring board approval.] or

[Not less than ____% of the authorized number of directors must approve the following corporate actions: *(e.g., appointment of officers, approval of loans in an amount greater than* $________*)]*

[FORM 4:A.1n]

Limiting Directors' Liability

The liability of the directors of the corporation for monetary damages shall be eliminated to the fullest extent permissible under California law.

[FORM 4:A.1*o*]

Authorizing Expanded Indemnification of Corporate Directors, Officers and Agents

The corporation is authorized to provide indemnification of agents (as defined in Section 317 of the Corporations Code) for breach of duty to the corporation and its stockholders through bylaw provisions or through agreements with the agents, or both, in excess of the indemnification otherwise permitted by Section 317 of the Corporations Code, subject to the limits on such excess indemnification set forth in Section 204 of the Corporations Code.

[FORM 4:A.1p]

Establishing Shareholder Qualification Requirements

VI

No person may qualify to be a shareholder of this corporation unless he or she *(e.g., is an employee of the corporation at the time the shares are purchased)*.

If any shareholder ceases to be qualified, the corporation shall have the option to purchase, and the shareholder shall have the obligation to sell, such shares within _____ days after the corporation learns that the shareholder is unqualified. The purchase price of such shares shall be *[equal to their fair value. If the shareholder and corporation cannot agree on a price, they shall each name an independent arbitrator. If the two arbitrators cannot agree on a price, they shall name a third independent arbitrator, who must consult with the other two arbitrators. The decision of the third arbitrator shall be final.]* or *[computed according to the following formula: (e.g., book value, capitalized earnings, etc.; see para. 1:107 ff., and Form 3:B, Section 5.)]*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[FORM 4:A.1q]

Establishing Shareholders' Right to Determine Consideration for Share Issuances

VI

If any shares are outstanding, the vote or written consent of at least ____% *[e.g., a majority]* of the outstanding shares entitled to vote is required to approve the consideration for the issuance of any additional shares.

[FORM 4:A.1r]

Establishing Assessability of Shares

VI

The board of directors may levy assessments upon the outstanding shares of the corporation. *(Such assessments may not exceed* $________ *per share per year.)(At least* ____% *of the outstanding shares must also approve such assessments)*.

(In addition to the forfeiture and sale remedies provided by Section 423 of the California Corporations Code*, the corporation may institute civil actions against shareholders to recover delinquent assessments.)*

[FORM 4:A.1s]

Requiring Super-Majority Vote of Shareholders

V

At least ____% of the outstanding shares entitled to vote must approve all corporate actions requiring shareholder approval, except for the election or removal of directors and an election to wind up and dissolve the corporation.

(At least ____% *of the outstanding shares entitled to vote must approve any amendment to these articles (or: to this article).)*

[FORM 4:A.1t]

Creating “Classified Board”

IV

This corporation is authorized to issue two classes of shares designated respectively “Class A Common Stock” and “Class B Common Stock.” _____ shares of Class A Common Stock may be issued. _____ shares of Class B Common Stock may be issued. The only distinction between the two classes is as follows: The holders of the Class A Common Stock have the right to elect, as a class, *(e.g., two)* directors of the corporation; and the holders of the Class B Common Stock have the right to elect, as a class, *(e.g., one)* director of the corporation.

[FORM 4:A.1u]

Requiring Shareholder Approval for Specified Actions

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

V

At least ____% of the outstanding shares entitled to vote must approve the following corporate actions: *(e.g., the amendment or repeal of bylaws; compensation of officers, etc.)*.

[FORM 4:A.1v]

Establishing Primacy of Buy-Out Agreement Upon Dissolution

If proceedings for dissolution of the corporation to which Corporations Code Section 2000 applies are instituted, the provisions of any Buy-Out Agreement then in effect among the corporation's shareholders shall govern and supersede any provisions of Section 2000 inconsistent therewith, to the extent required to enforce such agreement.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 4:A.2

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

Forms

[Form 4:A.2] Certificate of Determination

CERTIFICATE OF DETERMINATION OF

___________ CORPORATION

___________ and ___________ certify that:

1. They are the *(President or Vice President or Chair of the Board)* and the *(Secretary or Chief Financial Officer or Treasurer or Assistant Secretary or Assistant Treasurer)* of ___________, a California corporation.
2. The corporation is authorized to issue _____ shares of *(specify class or series)*, none of which has been issued.
3. The following resolution was duly adopted by the board of directors:

WHEREAS, the board of directors is authorized by the Articles of Incorporation to divide the Preferred Stock into any number of series, and to fix the designation and number of shares of such series, and to determine the rights, preferences privileges and restrictions of any wholly unissued series of Preferred Stock,

BE IT RESOLVED, that the Board of Directors hereby establishes a series of Preferred Stock as follows:

(a) Such series of Preferred Stock is designated *(specify: e.g., "Series A" or "Preferred Stock".)* The number of shares of such series is _____.

(b) *(Insert applicable rights, preferences, privileges and restrictions; See Forms 4:A.1c ff.)*

We declare that we are the persons who executed the foregoing Certificate of Determination and that this instrument is the act and deed of the undersigned.

Dated: ___________ ___________

(President)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

____

(Secretary)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 4:A.3

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

Forms

[Form 4:A.3] Articles Designating Initial Directors

ARTICLES OF INCORPORATION

OF

____

I

The name of this corporation is ___________.

II

The purpose of this corporation is to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law of California other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code.

III

The initial street address of the corporation is: _____________________.

[If the corporation's initial mailing address is different from its initial street address:]

The initial mailing address of the corporation is: _____________________.

IV

The name and address in the State of California of this corporation's initial agent for service of process is: _____________________.

V

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

This corporation is authorized to issue only one class of shares of stock; and the total number of shares which this corporation is authorized to issue is ________________.

VI

The initial directors of this corporation are:

Name	*Address*
Name	*Address*
Name	*Address*
DATED: ___________	
	(Signature of Director)
	(Signature of Director)
	(Signature of Director)

The undersigned, being all the persons named above as the initial directors, declare that they are the persons who executed the foregoing Articles of Incorporation, and that this instrument is the act and deed of the undersigned.

____
(Signature of Director)

____
(Signature of Director)

____
(Signature of Director)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 4:A.4

The Rutter Group | July 2024 Update

California Practice Guide--Corporations

Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

Forms

[Form 4:A.4] Disclaimer of Appointment

Image 1 within document in PDF format.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 4:B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

Forms

[Form 4:B] Bylaws

BYLAWS OF

____

A California Corporation

ARTICLE I
DIRECTORS; MANAGEMENT

Section 1. Powers

Subject to the provisions of the General Corporation Law of California, and subject to any limitation in the Articles of Incorporation and the Bylaws relating to action required to be approved by the Shareholders or by the outstanding shares, the business and affairs of this corporation shall be managed by and all corporate powers shall be exercised by or under the direction of the Board of Directors.

Section 2. Number and Qualification of the Board.

The authorized number of Directors of the corporation shall be _____. This number may be changed by amendment to the Articles of Incorporation or by amendment to this Section 2, of Article I of these Bylaws, adopted by the vote or written consent of the Shareholders entitled to exercise majority voting power, as provided in California Corporations Code Section 212.

Section 3. Election and Term of Office of Directors.

Directors shall be elected at each annual meeting of the Shareholders to hold office until the next annual meeting and until their successors are duly elected and qualified. Each Director, including a Director elected to fill a vacancy, shall hold office until expiration of the term for which elected and until a successor has been elected and qualified.

Section 4. Vacancies.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

A vacancy in the Board of Directors shall be deemed to exist in the event of the death, resignation, or removal of any Director, or if the Shareholders fail, at any meeting of the Shareholders at which any Directors are elected, to elect the full number of authorized Directors.

Vacancies may be filled by a majority of the remaining Directors, although less than a quorum, or by a sole remaining Director, except that a vacancy created by the removal of a Director may be filled only by the Shareholders, either by vote of the majority of the shares entitled to vote represented at a duly held meeting at which a quorum is present, or by the written consent of holders of all of the outstanding shares entitled to vote. Each Director so elected shall hold office until the next annual meeting of the Shareholders and until a successor has been elected and qualified.

The Shareholders may elect a Director or Directors to fill any other vacancy or vacancies not filled by the Directors. If made by written consent, any such election shall, except as provided above with respect to vacancies caused by the removal of a Director, require consent of only a majority of the outstanding shares entitled to vote.

Any Director may resign effective upon giving written notice to the Chairperson of the Board, the President, the Secretary, or the Board of Directors, unless the notice specifies a later time for that resignation to become effective. If the resignation of a Director is effective at a future time, the Board of Directors may elect a successor to take office when the resignation becomes effective.

No reduction of the authorized number of Directors shall have the effect of removing any Director before the Director's term of office expires.

Section 5. Removal of Directors.

The entire Board of Directors or any individual Director may be removed from office as provided by Sections 302, 303 and 304 of the California Corporations Code. In such a case, the remaining Board Members may elect a successor Director to fill such vacancy for the removed Director's remaining unexpired term. No Director may be removed (unless the entire Board is removed) when the votes cast against removal or not consenting in writing to such removal would be sufficient to elect such Director if voted cumulatively at an election at which the same total number of votes were cast (or, if such action is taken by written consent, all shares entitled to vote were voted) and the entire number of Directors authorized at the time of the Directors most recent election were then being elected; and when by the provisions of Articles the holders of the shares of any class or series voting as a class or series are entitled to elect one or more Directors, any Director so elected may be removed only by the applicable vote of the holders of the shares of that class or series.

Section 6. Place of Meetings.

Regular meetings of the Board of Directors shall be held at any place within or without the State designated from time to time by Board resolution. Absent such resolution, regular meetings shall be held at the corporation's principal office. Special meetings shall be held at any place within or without the State designated in the notice of the meeting or, if not stated in the notice or there is no notice, at the corporation's principal office.

Any meeting may be held by conference telephone, or video screen communication, and participation in such meeting shall constitute presence at such meeting, so long as all Directors participating in such meeting can hear one another.

Any meeting may be held by electronic mail, electronic video screen communication, conference telephone, electronic transmission or other means of remote communication, and participation in such meeting shall constitute presence at such meeting, so long as (i) each Director participating in the meeting can communicate with all of the others concurrently; (ii) each Director is provided with the means of participating in all matters before the Board, including the capacity to propose or object to a specific action proposed to be taken by the corporation.

Section 7. Annual Meetings.

Immediately following each annual meeting of Shareholders, the Board of Directors shall hold a regular meeting for the purpose of organization, the election of officers and the transaction of other business. Notice of this meeting shall not be required. Minutes of any meeting of the Board, or any committee thereof, shall be maintained as required by Section 1500 of the California Corporations Code by the Secretary or other officer designated for that purpose.

Section 8. Other Regular Meetings.

Other regular meetings of the Board of Directors shall be held without call at such time as shall from time to time be fixed by the Board of Directors. Such regular meetings may be held without notice, provided the time and place has been fixed by the Board of Directors, and further provided that notice of any change in the time of such meeting shall be given to all the Directors. Notice of a change in the time shall be given to each Director in the same manner as notice for special meetings of the Board of Directors.

If said day falls upon a holiday, such meetings shall be held on the next succeeding day thereafter.

Section 9. Special Meetings/Notices.

Special meetings of the Board of Directors for any purpose or purposes may be called at any time by the Chairperson of the Board or the President or any Vice President or the Secretary or any two Directors.

Notice of the time and place for special meetings shall be delivered to each Director personally, or be given by telephone (including a voice messaging system), facsimile, electronic mail or other electronic means, or be sent by first class mail addressed to each Director at his or her address as shown in the records of the corporation. If such notice is mailed, it shall be deposited in the United States mail at least four (4) days before the time of the holding of the meeting. If such notice is delivered personally or by telephone, facsimile, electronic mail or other electronic means, it shall be so delivered at least forty-eight (48) hours before the time of the holding of the meeting. Any oral notice given personally or by telephone may be communicated to either the Director or a person at the office of the Director whom the person giving the notice has reason to believe will promptly communicate it to the Director. During an "emergency," as described in Article IX, Section 1, when notice of a meeting by the Board cannot be given to that Director or Directors in the manner prescribed by these Bylaws or by California Corporations Code Section 307, notice may be given in any practicable manner under the circumstances, including, but not limited to, by publication, Internet and radio.

The notice need not specify the purpose of the meeting, nor the place, if the meeting is to be held at the principal office of the corporation.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Section 10. Waiver of Notice.

The transactions of any meeting of the Board of Directors, however called, noticed, or wherever held, shall be as valid as though had at a meeting duly held after the regular call and notice if a quorum be present and if, either before or after the meeting, each of the Directors not present signs or otherwise provides a written waiver of notice, a consent to holding the meeting or an approval of the minutes thereof. Waiver of notices or consents need not specify the purpose of the meeting.

All such waivers, consents and approvals shall be filed with the corporate records or made part of the minutes of the meeting. Notice of a meeting shall also be deemed given to any Director who attends without protesting the lack of notice to such Director. A majority of the authorized number of Directors shall constitute a quorum for the transaction of business, except to adjourn as provided in Section 12 of this Article I. During an "emergency," as described in Article IX, Section 1, the Directors present at a meeting may appoint one or more officers of the corporation present at the meeting to act as a Director, in order of rank and within the same rank in order of seniority, as necessary to achieve a quorum for that meeting. Every act or decision done or made by a majority of the Directors present at a meeting duly held at which a quorum was present shall be regarded as the act of the Board of Directors, subject to the provisions of California Corporations Code Sections 310, 311 and 317(e). A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of Directors, if any action taken is approved by at least a majority of the required quorum for that meeting.

Section 11. Adjournment.

A majority of the Directors present, whether or not constituting a quorum, may adjourn any meeting to another time and place.

Section 12. Notice of Adjournment.

Notice of the time and place of the holding of an adjourned meeting need not be given, unless the meeting is adjourned for more than twenty-four (24) hours, in which case such notice shall be given before the time of the adjourned meeting to the Directors who were not present at the time of the adjournment.

Section 13. Sole Director Provided by Articles of Incorporation.

In the event only one Director is required by the Bylaws or Articles of Incorporation, any references herein to notices, waivers, consents, meetings, or other actions by the majority or quorum of Directors shall be deemed notice, waiver, etc. by such sole Director, who shall have all the rights and duties and shall be entitled to exercise all the powers and shall assume all the responsibilities otherwise herein described given to a Board of Directors.

Section 14. Directors Acting by Unanimous Written Consent.

Any action required or permitted to be taken by the Board of Directors may be taken without a meeting if all the then-serving Directors individually or collectively execute a written consent or consents authorizing such action and if the number of then-serving Directors constitute a quorum of the Board. (But Directors constituting less than a quorum may act by written consent to fill vacancies on the Board as provided in Section 4 of Article I of these Bylaws.)

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

An action may be taken by written consent notwithstanding that a Director (or more than one Director) abstains in writing on the ground that the action involves a transaction with either (i) the abstaining Director, (ii) a corporation, firm or association in which the abstaining Director has a material financial interest, or (iii) a corporation in which the abstaining Director is also a director. In any such circumstances involving an abstaining Director (or more than one abstaining Director), an action may be taken by the written consent of the remaining Directors so long as (i) the material facts of the transaction and the abstaining Director's interest are fully disclosed in writing to the remaining Directors before they execute the consent, and (ii) all the remaining Directors approve the action and their approval is sufficient to approve the transaction without counting the abstaining Director. The disclosure so made shall be included prominently in the consent executed by the remaining Directors.

Any written consent taken in lieu of a meeting shall be filed with the regular minutes of the Board.

Section 15. Fees and Compensation of Directors.

Directors and members of a Directors' Committee may receive such compensation for their services, and such reimbursement of expenses, as may be fixed or determined by resolution of the Board of Directors. Nothing herein shall be construed to preclude any Director from serving the corporation in any other capacity as an officer, employee, or otherwise, and receiving compensation for such services.

Section 16. Committees.

Committees of the Board may be appointed by resolution passed by a majority of the whole Board. Committees shall be composed of two (2) or more members of the Board and shall have such powers of the Board as may be expressly delegated to them by resolution of the Board of Directors. The Board may designate one (1) or more Directors as alternate members of any committee, who may replace any absent member at any meeting of the committee. Each committee shall have such powers of the Board of Directors as may be expressly delegated to it by resolution of the Board of Directors except those powers expressly made nondelegable by California Corporations Code Section 311.

Section 17. Meetings and Action of Committees.

Committee meetings and action of committees shall be governed by, and held and taken in accordance with, the provisions of Article I, Sections 6, 8, 9, 10, 11, 12, and 14, with such changes in the context of those Sections as are necessary to substitute the committee and its members for the Board of Directors and its members, except that the time of the regular meetings of committees may be determined by resolution of the Board of Directors as well as the committee, and special meetings of committees may also be called by resolutions of the Board of Directors and notice of special meetings of committees shall also be given to all alternate members, who shall have the right to attend all meetings of the committee. The Board of Directors may adopt rules for the government of any committee not inconsistent with the provisions of these Bylaws.

Section 18. Advisory Directors.

The Board of Directors from time to time may elect one (1) or more persons to be advisory Directors, who shall not by such appointment be members of the Board of Directors. Advisory Directors shall be available from time to time to perform special assignments specified by the President, to attend meetings of the Board of Directors upon invitation and to furnish consultation to the Board. The period during which the title shall be held may be prescribed by the Board of Directors. If no period is prescribed, title shall be held at the pleasure of the Board.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

ARTICLE II
OFFICERS

Section 1. Officers.

The principal officers of the corporation shall be a Chairperson of the Board or a President or both, a Secretary and a Chief Financial Officer who may also be called Treasurer. The corporation may also have, at the discretion of the Board of Directors, one or more Vice Presidents, one or more Assistant Secretaries, and such other officers as may be appointed in accordance with the provision of Section 3 of this Article. One person may hold two or more offices.

Section 2. Election of Officers.

The principal officers of the corporation, except such officers as may be appointed in accordance with the provisions of Section 3 of this Article, shall be chosen by the Board of Directors, and each shall serve at the pleasure of the Board of Directors, subject to the rights, if any, of an officer under any contract of employment.

Section 3. Subordinate Officers, Etc.

The Board of Directors may empower the President to appoint and remove such officers (other than the principal officers) as the business of the corporation may require, each of whom shall hold office for such period, have such authority and perform such duties as are provided in the Bylaws or as the Board of Directors may from time to time determine.

Section 4. Removal and Resignation of Officers.

Subject to the rights, if any, of an officer under any contract of employment, any officer may be removed, either with or without cause, by a majority of the Directors at that time in office, at any regular or special meeting of the Board, or, excepting the case of an officer chosen by the Board of Directors, by any officer upon whom such power of removal may be conferred by the Board of Directors.

Section 5. Vacancies in Office.

A vacancy in any office because of death, resignation, removal, disqualification, or any other cause shall be filled in the manner prescribed in these Bylaws for regular appointments to such office.

Section 6. Chairperson of the Board.

The Chairperson of the Board, if such an officer be elected, shall, if present, preside at all meetings of the Board of Directors and exercise and perform such other powers and duties as may from time to time be assigned to him or her by the Board of Directors or prescribed by the Bylaws. If there is no President, the Chairperson of the Board shall in addition be the Chief Executive Officer of the corporation and shall have the powers and duties prescribed in Section 7 of this Article.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Section 7. President.

Subject to such supervisory powers, if any, as may be given by the Board of Directors to the Chairperson of the Board, if there be such an officer, the President shall be the Chief Executive Officer of the corporation and shall, subject to the control of the Board of Directors, have general supervision, direction and control of the business and the officers of the corporation. He or she shall preside at all the meetings of the Shareholders and, in the absence of the Chairperson of the Board, or if there be none, at all meetings of Shareholders and, in the absence of the Chairperson of the Board, or if there be none, at all meetings of the Board of Directors. He or she shall have the general powers and duties of management usually vested in the office of President of a corporation, shall be ex officio a member of all the standing committees, including the executive committee, if any, and shall have such other powers and duties as may be described by the Board of Directors or the Bylaws.

Section 8. Vice Presidents.

In the absence or disability of the President, the Vice Presidents, if any, in order of their rank as fixed by the Board of Directors, shall perform all the duties of the President, and so acting shall have all the powers of, and be subject to the restrictions upon, the President. The Vice Presidents shall have such other powers and perform such other duties as from time to time may be prescribed for them respectively by the Board of Directors or the Bylaws, the President, or the Chairperson of the Board.

Section 9. Secretary.

The Secretary shall keep or cause to be kept at the principal office or such other place as the Board of Directors may order, a book of minutes of all meetings of Directors, Committees of Directors, and Shareholders, with the time and place of holding, whether regular or special, and, if special, how authorized, the notice thereof given, the names of those present at Directors and Committee meetings, the number of shares present or represented at Shareholders meetings, and the proceedings thereof.

The Secretary shall keep or cause to be kept at the principal office or at the office of the corporation's transfer agent, a share register, or duplicate share register, showing the names of the shareholders and their addresses; the number of classes of shares held by each; the number and date of certificates issued for the same; and the number and date of cancellation of every certificate surrendered for cancellation.

The Secretary shall give or cause to be given notice of all meetings of the Shareholders and of the Board of Directors required by the Bylaws or by law to be given, shall keep the seal of the corporation (if any) in safe custody, and shall have such other powers and perform such other duties as may be prescribed by the Board of Directors or by the Bylaws.

Section 10. Chief Financial Officer.

The Chief Financial Officer shall keep and maintain, or cause to be kept and maintained, adequate and correct books and records of accounts of the properties and business transactions of the corporation, including accounts of its assets, liabilities, receipts, disbursements, gains, losses, capital, retained earnings and shares. The books of account shall at all reasonable times be open to inspection by any Director.

The Chief Financial Officer shall deposit all moneys and other valuables in the name and to the credit of the corporation with such depositories as may be designated by the Board of Directors. He or she shall disburse the funds of the corporation as may

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

be ordered by the Board of Directors, shall render to the President and Directors, whenever they request it, an account of all of his or her transactions as Chief Financial Officer and of the financial condition and results of operation of the corporation, and shall have other powers and perform such other duties as may be prescribed by the Board of Directors or the Bylaws.

ARTICLE III
MEETING OF SHAREHOLDERS

Section 1. Place of Meetings.

Unless all Shareholders consent to a meeting by electronic transmission as set forth in Section 2 of this Article, meetings of Shareholders shall be held at a physical location, which may be any place within or without the State of California designated by the Board of Directors. In the absence of such designation, Shareholders' meetings shall be held at the principal office of the corporation.

Section 2. Meetings Using Video Screen or Electronic Communication.

Meetings of the Shareholders may be conducted, either in whole or in part, by conference telephone or electronic video screen communication. Meetings may also be conducted, in whole or in part, by electronic transmission (other than conference telephone or electronic video screen communication) if all Shareholders consent thereto and none of such consents is revoked prior to the holding of the meeting. A request by the corporation to the Shareholders for consent to conduct a meeting of Shareholders by electronic transmission may be made in the same manner as a notice of Shareholders meeting as set forth in Section 4 of this Article and shall include a statement that, absent consent of each Shareholder to conduct a meeting by electronic transmission, the meeting shall be held at a physical location in accordance with Section 1 of this Article.

Shareholders not physically present (in person or by proxy) at a meeting may, by conference telephone, electronic video screen communication or electronic transmission, be deemed present and may participate and vote at the meeting. When conducting any meeting in whole or in part by conference telephone, electronic video screen communication or electronic transmission, the corporation shall implement reasonable measures to provide Shareholders a reasonable opportunity to read or hear the proceedings in real time as the proceedings occur and to vote on matters submitted thereat for Shareholder vote.

The corporation shall maintain a record of any Shareholder vote or other action taken by means of conference telephone, electronic video screen communication or electronic transmission.

Section 3. Annual Meeting.

The annual meeting of the Shareholders shall be held on ____________. If this day be a legal holiday, the meeting shall be held on the next succeeding business day, at the same time. At the annual meeting, the Shareholders shall elect a Board of Directors and transact such other business as may properly be brought before the meeting. If the above date is inconvenient, the annual meeting of Shareholders shall be held each year on a date and at a time designated by the Board of Directors within twenty (20) days of the above date upon proper notice to all Shareholders.

Section 4. Special Meetings.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

A special meeting of the Shareholders, for any purpose or purposes whatsoever, may be called at any time by the Board of Directors, or by the Chairperson of the Board of Directors, or by the President, or by one or more Shareholders holding shares in the aggregate entitled to cast not less than 10% of the votes at any such meeting.

If a special meeting is called by any person or persons other than the Board of Directors, the request shall be in writing, specifying the time of such meeting and the general nature of the business proposed to be transacted, and shall be delivered personally or sent by registered mail or by telegraphic or other facsimile transmission to the Chairperson of the Board, the President, any Vice President or the Secretary of the corporation. The officer receiving such request shall forthwith cause notice to be given to the Shareholders entitled to vote, in accordance with the provisions of Sections 5 and 6 of this Article, that a meeting will be held at the time requested by the person or persons calling the meeting, not less than thirty-five (35) nor more than sixty (60) days after the receipt of the request. If the notice is not given within twenty (20) days after receipt of the request, the person or persons requesting the meeting may give the notice in the manner provided in these Bylaws or upon application to the Superior Court as provided in California Corporations Code Section 601(c). Nothing contained in this paragraph of this Section shall be construed as limiting, fixing or affecting the time when a meeting of Shareholders called by action of the Board of Directors may be held.

Section 5. Notice of Meetings; Reports.

Notice of meetings, annual or special, shall be given in writing not less than ten (10) nor more than sixty (60) days before the date of the meeting, to Shareholders entitled to vote thereat by the Secretary or the Assistant Secretary, or if there be no such officer, or in the case of his or her neglect or refusal, by any Director or Shareholder.

Such notices or any reports shall be given personally or by mail, or other means of communication as provided in California Corporations Code Section 601, and shall be sent to the Shareholder's address appearing on the books of the corporation, or supplied by him or her to the corporation for the purposes of notice, and in absence thereof as provided in California Corporations Code Section 601 by posting notice at a place where the corporation's principal office is located or by publication at least once in a newspaper of general circulation in the county in which the principal office is located. Notice of any meeting of Shareholders shall specify the place, date and hour of the meeting and (i) in the case of a special meeting, the general nature of the business to be transacted, and no other business may be transacted, or (ii) in the case of an annual meeting, those matters which the Board of Directors, at the date of the mailing of notice, intends to present for action by the Shareholders. At any meetings where Directors are elected, notice shall include the names of the nominees, if any, intended at the date of notice to be presented by the management for election.

If action is proposed to be taken at any meeting for approval of (i) contracts or transactions in which a Director has a direct or indirect financial interest, pursuant to California Corporations Code Section 310, (ii) an amendment to the Articles of Incorporation, pursuant to Section 902 of such Code, (iii) a reorganization of the corporation, pursuant to Section 1201 of such Code, (iv) dissolution of the corporation, pursuant to Section 1900 of such Code, or (v) a distribution to preferred Shareholders, pursuant to Section 2007 of the Code, the notice shall also state the general nature of such proposal.

Section 6. Quorum.

The presence in person or by proxy of the holders of a majority of the shares entitled to vote at any meeting of Shareholders shall constitute a quorum for the transaction of business. The Shareholders present in person or by proxy at a duly called or held meeting at which a quorum is present may continue to do business until adjournment, notwithstanding the withdrawal of enough Shareholders to leave less than a quorum, if any action taken (other than adjournment) is approved by a majority of

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

the shares required to constitute a quorum, or such greater percentage vote, or by voting by class, as may be required by the Articles of Incorporation or the California Corporations Code.

Section 7. Adjourned Meeting and Notice Thereof.

Any Shareholders' meeting, annual or special, whether or not a quorum is present, may be adjourned from time to time by the vote of the majority of the shares represented at such meeting, either in person or by proxy, but in the absence of a quorum, no other business may be transacted at such meeting.

When any meeting of Shareholders, either annual or special, is adjourned to another time or place, notice need not be given of the adjourned meeting if the time and place thereof, or the means of electronic transmission or electronic video screen communication by which the Shareholders may participate, are announced at the meeting at which the adjournment is taken, unless a new record date for the adjourned meeting is fixed, or unless the adjournment is for more than forty-five (45) days from the date set for the original meeting, in which case the Board of Directors shall set a new record date. Notice of any such adjourned meeting shall be given to each Shareholder of record entitled to vote at the adjourned meeting in accordance with the provisions of Section 5 of this Article. At any adjourned meeting the corporation may transact any business which might have been transacted at the original meeting.

Section 8. Waiver of Notice or Consent by Absent Shareholders.

The transactions at any meeting of Shareholders, either annual or special, however called and noticed, and wherever held, shall be as valid as though had at a meeting duly held after regular call and notice, if a quorum be present either in person or by proxy, and if, either before or after the meeting, each person entitled to vote, not present in person or by proxy, signs or otherwise provides a written waiver of notice or a consent to a holding of the meeting, or any approval of the minutes thereof. The waiver of notice or consent need not specify either the business to be transacted or the purpose of any regular or special meeting of Shareholders, except that if action is taken or proposed to be taken for approval of any of those matters specified in the last paragraph of Section 5 of this Article, the waiver of notice or consent shall state the general nature of such proposal. All such waivers, consents or approvals shall be filed with the corporate records or made a part of the minutes of the meeting.

Attendance of a person at a meeting shall also constitute a waiver of notice of such meeting, except when the person objects, at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened, and except that attendance at a meeting is not a waiver of any right to object to the consideration of matters not included in the notice if such objection is expressly made at the meeting.

Section 9. Shareholders Acting Without a Meeting; Filling Vacancies on Board.

Any action that may be taken at a meeting of the Shareholders may be taken without a meeting or notice of meeting if authorized by a writing including a writing by facsimile, telegraphic or other electronic transmission, given by all of the Shareholders entitled to vote at a meeting for such purpose and filed with the Secretary of the corporation; provided that, while Directors ordinarily can be elected only by unanimous written consent under California Corporations Code Section 603(d), as to a vacancy created by causes other than removal, if the Directors fail to fill a vacancy, a person to fill that vacancy may be elected by the written consent of persons holding a majority of shares entitled to vote for the election of Directors.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Section 10. Other Actions Without a Meeting.

Unless otherwise provided in the General Corporation Law, any action that may be taken at an annual or special meeting of Shareholders may be taken without a meeting and without prior notice if a consent in writing, setting forth the action so taken, shall be signed by the holders of outstanding shares having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted.

Unless the consents of all Shareholders entitled to vote have been solicited in writing,

(a) Notice of any Shareholder approval pursuant to California Corporations Code Sections 310, 317, 1152, 1201 (except for a reorganization as to which Shareholders have the right to demand payment of cash for their shares) or 2007 without a meeting by less than unanimous written consent shall be given at least ten (10) days before the consummation of the action authorized by such approval; and

(b) Prompt notice shall be given of the taking of any other corporate action approved by Shareholders without a meeting by less than unanimous written consent, to each of those Shareholders entitled to vote who have not consented in writing.

Any Shareholder giving a written consent, or the Shareholder's proxyholder(s), or a transferee of the shares of a personal representative of the Shareholder or their respective proxyholder(s), may revoke the consent by a writing received by the corporation prior to the time that written consents of the number of shares required to authorize the proposed action have been filed with the Secretary of the corporation, but may not do so thereafter. Such revocation is effective upon its receipt by the Secretary.

Section 11. Voting Rights; Cumulative Voting.

Only persons in whose names shares entitled to vote stand on the stock records of the corporation on the day fixed by the Board of Directors for the determination of the Shareholders of record, shall be entitled to vote at any Shareholders' meeting.

Provided the candidate's name has been placed in nomination prior to the voting and one or more Shareholders have given notice at the meeting prior to voting of the Shareholder's intent to cumulate the Shareholder's votes, every Shareholder entitled to vote at any election for Director of any corporation for profit may cumulate his or her votes and give one candidate a number of votes equal to the number of Directors to be elected multiplied by the number of votes to which his or her shares are entitled, or distribute his or her votes on the same principle among as many candidates as he or she thinks fit.

The candidates receiving the highest number of votes up to the number of Directors to be elected are elected.

The Board of Directors may fix a time as a record date for the determination of the Shareholders entitled to notice of and to vote at any such meeting, or entitled to receive any such dividend or distribution, or any allotment, rights, or to exercise the rights in respect to any such change, conversion, or exchange of shares. In such case only Shareholders of record on the date so fixed shall be entitled to notice of and to vote at such meeting, or to receive such dividends, distribution, or allotment of rights or to exercise such rights, as the case may be, notwithstanding a transfer of any share on the books of the company after any record date fixed as aforesaid.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Section 12. Proxies.

Every Shareholder entitled to vote for Directors or on any other matter shall have the right to do so either in person or by one or more agents authorized by a proxy validly executed by the Shareholder. A proxy may be executed by written authorization signed, or by electronic transmission authorized, by the Shareholder or the Shareholder's attorney in fact, giving the proxyholder(s) the power to vote the Shareholder's shares. A proxy shall be deemed signed if the Shareholder's name or other authorization is placed on the proxy (whether by manual signature, typewriting, telegraphic or electronic transmission or otherwise) by the Shareholder or the Shareholder's attorney in fact. A proxy may also be transmitted orally by telephone if submitted with information from which it may be determined that the proxy was authorized by the Shareholder or the Shareholder's attorney in fact.

A validly executed proxy which does not state that it is irrevocable shall continue in full force and effect unless revoked by the person executing it, prior to the vote pursuant thereto, by a writing delivered to the corporation stating that the proxy is revoked or by a subsequent proxy executed by, or attendance at the meeting and voting in person by the person executing the proxy; provided, however, that no such proxy shall be valid after the expiration of eleven (11) months from the date of the proxy, unless otherwise provided in the proxy. The revocability of a proxy that states on its face that it is irrevocable shall be governed by the provisions of California Corporations Code Section 705(e) and (f).

Section 13. Chairperson and Secretary of Meeting.

The President, or in the absence of the President, any Vice President, shall call the meeting of the Shareholders to order, and shall act as Chairperson of the meeting. In the absence of the President and all the Vice Presidents, Shareholders shall appoint a Chairperson at the meeting. The Secretary of the Corporation shall act as Secretary of all meetings of the Shareholders, but in the absence of the Secretary at any meeting of the Shareholders, the presiding officer shall appoint any person to act as such Secretary of the meeting.

Section 14. Inspectors of Election.

Before any meeting of Shareholders, the Board of Directors may appoint any person other than nominees for office to act as inspectors of election at the meeting or its adjournment. If no inspectors of election are appointed, the Chairperson of the meeting may, and on the request of any Shareholder or his or her proxy shall, appoint inspectors of election at the meeting. The number of inspectors shall be either one (1) or three (3). If inspectors are appointed at a meeting on the request of one or more Shareholders or proxies, the holders of a majority of shares or their proxies present at the meeting shall determine whether one (1) or three (3) inspectors are to be appointed. If any person appointed as inspector fails to appear or fails or refuses to act, the vacancy may be filled by appointment by the Board of Directors before the meeting, or by the Chairperson at the meeting.

The duties of these inspectors shall be as follows:

(a) Determine the number of shares outstanding and the voting power of each, the shares represented at the meeting, the existence of a quorum, and the authenticity, validity, and effect of proxies;

(b) Receive votes, ballots, or consents;

(c) Hear and determine all challenges and questions in any way arising in connection with the right to vote;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(d) Count and tabulate all votes or consents;

(e) Determine the election result; and

(f) Do any other acts that may be proper to conduct the election or vote with fairness to all Shareholders.

ARTICLE IV
CERTIFICATES AND TRANSFERS OF SHARES

Section 1. Certificates for Shares.

Certificates for shares shall be of such form and device as the Board of Directors may designate and shall state the name of the record holder of the shares represented thereby; its number and date of issuance; the number of shares for which it is issued; a statement of the rights, privileges, preferences and restrictions, if any; a statement as to the redemption or conversion, if any; a statement of liens or restrictions upon transfer or voting, if any; and if the shares be assessable, or if assessments are collectible by personal action, a plain statement of such facts.

Every certificate for shares must be signed by the President or a Vice President and a Secretary or an Assistant Secretary, and must be authenticated by the signature of the President and Secretary or an Assistant Secretary. No certificate or certificates for shares are to be issued until such shares are fully paid, unless the Board authorizes the issuance of certificates or shares as partly paid, provided that such certificates shall state the amount of consideration to be paid therefor and the amount paid thereon.

Section 2. Transfer on the Books.

Upon surrender to the Secretary or transfer agent of the corporation of a certificate for shares duly endorsed or accompanied by proper evidence of succession, assignment or authority to transfer, it shall be the duty of the corporation to issue a new certificate to the person entitled thereto, cancel the old certificate, and record the transaction on its books.

Section 3. Lost or Destroyed Certificates.

Any person claiming a certificate of stock to be lost or destroyed shall make an affidavit or affirmation of that fact and shall, if the Directors so require, give the corporation a bond of indemnity, in the form and with one or more sureties satisfactory to the Board, in at least double the value of the stock represented by said certificate, whereupon a new certificate may be issued in the same manner and for the same number of shares as the one alleged to be lost or destroyed.

Section 4. Transfer Agents and Registrars.

The Board of Directors may appoint one or more transfer agents or transfer clerks and one or more registrars, which shall be an incorporated domestic bank or trust company, which shall be appointed at such times and places as the requirements of the corporation may necessitate and the Directors may designate.

Section 5. Record Date; Closing Stock Transfer Books.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

In order that the corporation may determine the Shareholders entitled to notice of any meeting or to vote or entitled to receive payment of any dividend or other distribution or allotment of any rights or entitled to exercise any rights in respect of any lawful action, the Board may fix in advance, a record date, which shall not be more than sixty (60) nor less than ten (10) days prior to the date of such meeting nor more than sixty (60) days prior to any other action. If no record date is fixed:

(a) The record date for determining Shareholders entitled to notice of or to vote at a meeting of Shareholders shall be at the close of the business on the business day next preceding the day on which notice is given or, if notice is waived, at close of business on the business day next preceding the day on which the meeting is held.

(b) The record date for determining Shareholders entitled to give consent to corporate action in writing without a meeting, when no prior action by the Board is necessary, shall be the day on which the first written consent is given.

(c) The record date for determining Shareholders for any other purpose shall be the close of business on the day on which the Board adopts the resolution relating thereto, or the sixtieth (60th) day prior to the date of such other action, whichever is later.

The Board of Directors may close the books of the company against transfers of shares during the whole or any part of such period.

Section 6. Legend Condition.

In the event any shares of this corporation are issued pursuant to a permit or exemption therefrom requiring the imposition of a legend condition, the person or persons issuing or transferring said shares shall cause said legend to be placed on the certificate and on the stub relating thereto in the stock record book and shall not be required to transfer any shares free of such legend unless an amendment to such permit or a new permit be first issued so authorizing said deletion.

Section 7. Close Corporation, Social Purpose Corporation or Benefit Corporation Certificates.

In the event this corporation shall elect to become a close corporation, social purpose corporation or benefit corporation, all certificates representing shares of this corporation shall contain the legend required by California Corporations Code Section 418(c), Section 2800(a) or Section 14631, respectively.

ARTICLE V
(OPTIONAL; *see ¶ 4:347*)
INDEMNIFICATION OF DIRECTORS, OFFICERS, EMPLOYEES AND AGENTS

The corporation may at its option, to the maximum extent permitted by the California General Corporation Law and by the articles, indemnify each of its agents against expenses, judgments, fines, settlements, and other amounts actually and reasonably incurred in connection with any proceeding arising by reason of the fact that such person is or was an agent of the corporation. For the purposes of this Section, an “agent” of the corporation includes any person who is or was a director, officer, employee or other agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, or was a director, officer, employee or agent of a foreign or domestic corporation which was a predecessor corporation of the corporation or of any other enterprise at the request of such predecessor corporation.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

ARTICLE VI
CORPORATE RECORDS AND REPORTS; INSPECTION

Section 1. Records.

The corporation shall maintain, in accordance with generally accepted accounting principles, adequate and correct accounts, books and records of its business and properties. If the corporation has fewer than one hundred (100) Shareholders, the financial statements need not be prepared according to generally accepted accounting principles so long as the financial statements reasonably set forth the assets and liabilities, income and expenses of the corporation, and disclose the accounting basis used. All of such books, records and accounts shall be kept at the corporation's principal office in the State of California, as fixed by the Board of Directors, from time to time, or at such place or places as designated by the Board of Directors, and shall be kept in either written form or another form capable of being converted into writing, or in any combination of the foregoing. The books, records and minutes shall be open to inspection upon written demand of any Shareholder or holder of a voting trust certificate, at any reasonable time during usual business hours, for a purpose reasonably related to such holder's interest as a Shareholder or as the holder of a voting trust certificate. Such inspection may be made in person or by an agent or attorney, and shall include the right to copy and make extracts. The foregoing rights of inspection shall extend to the records of each subsidiary corporation.

Section 2. Maintenance and Inspection of Share Register.

The corporation shall keep at its principal office, or at the office of its transfer agent or registrar, if either be appointed and as determined by Board of Directors' resolution, a record of its Shareholders and the number and class of shares held by each. A Shareholder or Shareholders of the corporation holding at least five percent (5%) in the aggregate of the corporation's outstanding voting shares of the corporation may (i) inspect, and copy the records of Shareholder names and addresses and shareholding during usual business hours upon five (5) days' prior written demand upon the corporation, and/or (ii) obtain from the transfer agent of such transfer agent's usual charges for such a list, a list of the names and addresses of the Shareholders entitled to vote for the election of Directors, and their shareholdings, as of the most recent record date for which list has been compiled or as of a date specified by the Shareholders subsequent to the day of demand. Such list shall be made available by the transfer agent on or before the later of five (5) days after the demand is received or the date specified therein as the date as of which the list is to be compiled. The record of Shareholders shall also be open to inspection upon the written demand of any Shareholder or holder of a voting trust certificate, at any time during usual business hours, for a purpose reasonably related to such holder's interest as a Shareholder or as a holder of a voting trust certificate. Any inspection and copying under this Section may be made in person or by an agent or attorney of such Shareholder or holder of a voting trust certificate making such demand.

Section 3. Maintenance and Inspection of Bylaws.

The corporation shall keep at its principal office, or if its principal office is not in this state, at its principal business office in this state, the original or a copy of the Bylaws amended to date, which shall be open to inspection by the Shareholders at all reasonable times during office hours. If the principal office of the corporation is outside the state and the corporation has no principal business office in this state, the Secretary shall, upon written request of any Shareholder, furnish to such Shareholder a copy of the Bylaws as amended to date.

Section 4. Annual Report to Shareholders.

Provided this corporation has fewer than one hundred (100) Shareholders, the Annual Report to Shareholders referred to in Section 1501 of the General Corporation Law is expressly dispensed with, but nothing herein shall be interpreted as prohibiting

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

the Board of Directors from issuing annual or other periodic reports to Shareholders of the corporation as they deem appropriate. Should this corporation have one hundred (100) or more Shareholders, an Annual Report shall be furnished not later than one hundred twenty (120) days after the end of each fiscal period.

Section 5. Financial Statements.

A copy of any annual financial statement and any income statement of the corporation for each quarterly period of each fiscal year, and any accompanying balance sheet of the corporation as of the end of each such period, that has been prepared by the corporation shall be kept on file at the principal office of the corporation for twelve (12) months from the date of its execution, and each such statement shall be exhibited at all reasonable times to any Shareholder demanding an examination of such statement or a copy shall be made available to any such Shareholder.

If a Shareholder or Shareholders holding at least five percent (5%) of the outstanding shares of any class of stock of the corporation make a written request to the corporation for an income statement of the corporation for the three (3) month, six (6) month, or nine (9) month period of the then current fiscal year ended more than thirty (30) days prior to the date of the request, and a balance sheet of the corporation at the end of such period, the Chief Financial Officer shall cause such statement to be prepared, if not already prepared, and shall deliver personally or mail such statement or statements to the person making the request within thirty (30) days after the receipt of such request. If the corporation has not sent to the Shareholders its Annual Report for the last fiscal year, this report shall likewise be delivered or mailed to such Shareholder or Shareholders within thirty (30) days after such request.

The corporation also shall, upon the written request of any Shareholder, mail to the Shareholder a copy of the last annual, semi-annual or quarterly income statement that it has prepared and a balance sheet as of the end of such period. This quarterly income statement and balance sheet referred to in this Section shall be accompanied by the report thereon, if any, of any independent accountants engaged by the corporation or by the certificate of an authorized officer of the corporation that such financial statements were prepared without audit from the books and records of the corporation.

Section 6. Annual Statement of General Information.

The corporation shall, in a timely manner, file with the Secretary of State of California, on the prescribed form, a statement setting forth the authorized number of Directors, the names and complete business or residence addresses of all incumbent Directors, the names and complete business or residence addresses of the Chief Executive Officer, Secretary, and Chief Financial Officer, the street address of its principal office or principal business office in this state, the general type of business constituting the principal business activity of the corporation, and such other information as may be required by law, together with a designation of the agent of the corporation for the purpose of service of process, all in compliance with California Corporations Code Section 1502.

ARTICLE VII
GENERAL CORPORATE MATTERS

Section 1. Checks, Drafts, and Evidences of Indebtedness.

All checks, drafts or other orders for payment of money, notes or other evidences of indebtedness, issued in the name of or payable to the corporation, shall be signed or endorsed by such person or persons and in such manner as, from time to time, shall be determined by resolution of the Board of Directors.

Section 2. Corporate Contracts and Instruments, How Executed.

The Board of Directors, except as in the Bylaws otherwise provided, may authorize any officer or officers, agent or agents, to enter into any contract or execute any instrument in the name of and on behalf of the corporation, and such authority may be general or confined to specific instances; and, unless so authorized or ratified by the Board of Directors or within the agency power of any officer, no officer, agent or employee shall have any power or authority to bind the corporation by any contract or engagement or to pledge its credit or to render it liable for any purpose or to any amount.

Section 3. Representation of Shares of Other Corporation.

The Chairperson of the Board, the President, or any Vice President, or any other person authorized by resolution of the Board of Directors, is authorized to vote on behalf of the corporation any and all shares of any other corporation or corporations, foreign or domestic, standing in the name of the corporation. The authority herein granted to said officers to vote or represent on behalf of the corporation any and all shares held by the corporation in any other corporation or corporations may be exercised by any such officer in person or by any person authorized to do so by proxy duly elected by said officer.

Section 4. Construction and Definitions.

Unless the context requires otherwise, the general provisions, rules of construction, and the definitions of the California General Corporation Law shall govern the construction of these Bylaws. Without limiting the generality of the foregoing, the singular number includes the plural, the plural number includes the singular, and the term “person” includes a corporation, other form of entity, and a natural person.

ARTICLE VIII
AMENDMENTS TO BYLAWS

Section 1. Amendment by Shareholders.

New Bylaws may be adopted or these Bylaws may be amended or repealed by the vote or written consent of holders of a majority of the outstanding shares entitled to vote; provided, however, that if the Articles of Incorporation of the corporation set forth the number of authorized Directors of the corporation, the authorized number of Directors may be changed only by an amendment of the Articles of Incorporation.

Section 2. Amendment by Directors.

Subject to the rights of the Shareholders as provided in Section 1 of this Article to adopt, amend, or repeal Bylaws, and the limitation of California Corporations Code Sections 204(a)(5) and 212, Bylaws may be adopted, amended, or repealed by the Board of Directors.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

ARTICLE IX
EMERGENCY PROVISIONS

Section 1. General.

The provisions of this Article IX shall be operative only during one or more of the following events or circumstances as a result of which, and only so long as, a quorum of the corporation's Board of Directors cannot be readily convened for action (individually or collectively, an "Emergency"):

(a) A natural catastrophe, including, but not limited to, a hurricane, tornado, storm, high water, wind-driven water, tidal wave, tsunami, earthquake, volcanic eruption, landslide, mudslide, snowstorm, drought, epidemic, pandemic, or disease outbreak, or, regardless of cause, any fire, flood, or explosion;

(b) An attack on or within the State of California or on the public security of its residents by an enemy of the State of California or on the United States by an enemy of the United States, or upon receipt by the State of California of a warning from the federal government indicating that any such enemy attack is probable or imminent;

(c) An act of terrorism or other man-made disaster that results in extraordinary levels of casualties or damage or disruption severely affecting the infrastructure, environment, economy, government functions, or population, including, but not limited to, mass evacuations; or

(d) A state of emergency proclaimed by a governor or by the President of the United States.

In anticipation of or during an Emergency, the Board may take either or both of the following actions necessary to conduct the corporation's ordinary business operations and affairs:

(a) Modify lines of succession to accommodate the incapacity of any Director, officer, employee, or agent resulting from the Emergency; and

(b) Relocate the principal office of the corporation, designate alternative principal offices or regional offices of the corporation, or authorize the officers of the corporation to do so.

Section 2. Unavailable Directors.

All Directors of the corporation who are not available to perform their duties as Directors by reason of physical or mental incapacity or for any other reason or who are unwilling to perform their duties or whose whereabouts are unknown shall automatically cease to be Directors, with like effect as if such persons had resigned as Directors, so long as such unavailability continues.

Section 3. Authorized Number of Directors.

The authorized number of Directors shall be the number of Directors remaining after eliminating those who have ceased to be Directors pursuant to Section 2 of this Article IX, or the minimum number required by law, whichever number is greater.

Section 4. Quorum.

The number of Directors necessary to constitute a quorum shall be one-third of the authorized number of Directors as specified in Section 3 of this Article IX, or such other minimum number as, pursuant to applicable law or lawful decree then in force, it is possible for the bylaws of a corporation to specify.

Section 5. Creation of Emergency Committee.

In the event that the number of Directors remaining after eliminating those who have ceased to be Directors pursuant to Section 2 of this Article IX is less than the minimum number of authorized Directors required by law, then until the appointment of additional Director(s) to make up such required minimum, all the powers and authorities which the Board of Directors could by law delegate, including all powers and authorities which the Board of Directors could delegate to a committee, shall be automatically vested in an emergency committee, and the emergency committee shall thereafter manage the affairs of the corporation pursuant to such powers and authorities and shall have all other powers and authorities as may by law or lawful decree be conferred on any person or body of persons during a period of emergency.

Section 6. Constitution of Emergency Committee.

The emergency committee shall consist of all the Directors remaining after eliminating those who have ceased to be Directors pursuant to Section 2 of this Article IX, provided that such remaining Directors are not less than three in number or such fewer number of Directors as is permitted by law. In the event such remaining Directors are less than three in number (or such fewer permitted number), the emergency committee shall consist of three persons, who shall be the remaining Director or Directors and either one or two officers or employees of the corporation, as the remaining Director or Directors may in writing designate. If there is no remaining Director, the emergency committee shall consist of the three most senior officers of the corporation who are available to serve, and if and to the extent that officers are not available, the most senior employees of the corporation. Seniority shall be determined in accordance with any designation of seniority in the minutes of the proceedings of the Board, and, in the absence of such designation, shall be determined in order of rank and within the same rank in order of seniority. In the event that there are no remaining Directors and no officers or employees of the corporation available, the emergency committee shall consist of three persons designated in writing by the Shareholder owning the largest number of shares of record as of the date of the last record date.

Section 7. Powers of Emergency Committee.

The emergency committee, once appointed, shall adopt its own procedures and shall have the power to increase the number of members thereof beyond the original number, and, in the event of a vacancy or vacancies therein arising at any time, the remaining member or members of the emergency committee shall have the power to fill such vacancy or vacancies. In the event at any time after its appointment all members of the emergency committee shall die or resign or become unavailable to act for any reason whatsoever, a new emergency committee shall be appointed in accordance with the foregoing provisions of this Article IX. During an Emergency, the emergency committee may take either or both of the following actions necessary to conduct the corporation's ordinary business operations and affairs:

(a) Give notice to a Director or Directors in any practicable manner under the circumstances, including, but not limited to, by publication, Internet and radio, when notice of a meeting by the Board cannot be given to that Director or Directors in the manner prescribed by these Bylaws or by California Corporations Code Section 307.

(b) Appoint one or more officers of the corporation present at a Board meeting to act as a Director, in order of rank and within the same rank in order of seniority, as necessary to achieve a quorum for that meeting.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Section 8. Directors Becoming Available.

Any person who has ceased to be a Director pursuant to the provisions of Section 2 of this Article IX and who thereafter becomes available to serve as a Director shall automatically become a member of the emergency committee.

Section 9. Election of Board of Directors.

The emergency committee shall, as soon after its appointment as is practicable, take all requisite action to secure the election of a Board of Directors, and, upon such election, all the powers and authorities of the emergency committee shall cease.

Section 10. Action by Shareholders: Emergency Response.

In anticipation of or during an Emergency, the Board may take necessary and appropriate action to respond to the Emergency, mitigate its effects, or comply with lawful federal and state government orders, but the Board may not take any action that requires the vote of the Shareholders of the corporation, unless the required vote of the Shareholders was obtained prior to the Emergency.

Section 11. Termination of Emergency Committee.

In the event, after the appointment of an emergency committee, a sufficient number of persons who ceased to be Directors pursuant to Section 2 of this Article IX become available to serve as Directors, so that if they had not ceased to be Directors as aforesaid, there would be enough Directors to constitute the minimum number of Directors required by law, then all such persons shall automatically be deemed to be reappointed as Directors and the powers and authorities of the emergency committee shall be at an end.

Section 12. Application of Bylaws.

All provisions of these Bylaws other than this Article IX that are consistent with this Article IX shall remain effective during an Emergency, and the provisions of this Article IX shall not be effective after the Emergency ends.

Section 13. Actions Taken in Good Faith.

Any action taken in good faith in anticipation of or during an Emergency under this Article IX binds the corporation and may not be used to impose liability against a Director, officer, employee, or agent of the corporation.

ARTICLE X
MISCELLANEOUS

Section 1. References to Code Sections.

Section designations of three (3) digits or more herein refer to the General Corporation Law of California as effective January 1, 1977.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Section 2. Effect of Shareholders Agreement.

Any Shareholders agreement authorized by California Corporations Code Section 300(b) shall only be effective to modify the terms of these Bylaws if this corporation elects to become a close corporation with appropriate filing of or amendment to its Articles as required by California Corporations Code Section 202 and shall terminate when this corporation ceases to be a close corporation. Such an agreement cannot waive or alter Sections 158 (defining close corporations), 202 (requirements of Articles of Incorporation), 500 and 501 (relative to distribution), 111 (merger), 1201(e) (reorganization) or Chapter 15 (records and reports), Chapter 16 (inspection rights), Chapter 18 (involuntary dissolution), or Chapter 22 (crimes and penalties). Any other provisions of the Code or these Bylaws may be altered or waived thereby, but to the extent they are not so altered or waived these Bylaws shall be applicable.

Section 3. Subsidiary Corporations.

Shares of this corporation owned by a subsidiary shall not be entitled to vote on any matter. A subsidiary for these purposes is defined in California Corporations Code Section 189(a) and (b).

Section 4. Offices.

The Board of Directors shall fix the location of the principal office of the corporation at any place within or outside the State of California. If the principal office is located outside this state, and the corporation has one or more business offices in this state, the board of directors shall likewise fix and designate a principal business office in the State of California.

The Board of Directors may in its discretion establish from time to time branch or subordinate offices at any place or places within or outside the State of California.

CERTIFICATE

I, ________________, hereby certify that:

I am the Secretary of ________________ a California corporation; and

The foregoing Bylaws, consisting of _____ pages, are a true and correct copy of the Bylaws of the corporation as duly adopted by the Board of Directors of the corporation at a regular meeting duly held on ___________, at the corporation's principal office in ___________ County.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed the seal of the corporation this _____ day of ___________.

/s/___________
(Secretary)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 4:C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

Forms

[Form 4:C] Minutes of Action By Incorporators

MINUTES OF ACTION OF INCORPORATORS TAKEN

WITHOUT A MEETING BY WRITTEN CONSENT

The following action is taken by the incorporator(s) of *(name of corporation)* a California corporation, by written consent, without a meeting on *(date)*.

The following resolution approving a form of bylaws for the governance of this corporation is adopted:

RESOLVED, that the bylaws presented to the incorporator(s) be adopted as the bylaws of this corporation, and that a copy of those bylaws shall be inserted in the minute book of this corporation.

The following resolution electing the directors of the corporation is adopted:

RESOLVED, that pursuant to the foregoing bylaws, authorizing ___ directors, the following persons are hereby appointed as directors of this corporation for the ensuing year and until their successors have been elected and qualified:

....	....
(Name)	(Address)
....	....
(Name)	(Address)
....	....
(Name)	(Address)

The undersigned, the incorporator(s) of this corporation, consent(s) to the foregoing action.

DATED: _____ ________________

(Signature of Incorporator(s))

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 4:D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

Forms

[Form 4:D] Waiver of Notice and Consent to Holding of Organizational Meeting of Board of Directors

WAIVER OF NOTICE AND CONSENT TO HOLDING OF

ORGANIZATIONAL MEETING OF BOARD OF DIRECTORS

We, the undersigned, the director(s) of ___________ *(name of corporation)*, a California corporation, waive notice of the first meeting of the board of directors of the corporation on *(date)*, at *(address)*, California, and consent to this meeting being held at that time and place and to the transaction of any and all business by the directors at the meeting, including electing officers, adopting a corporate seal and form of share certificate, providing for the issuance of stock, and any other action that may be required or appropriate to complete the organization of the corporation.

DATED: _____ ________________

(Signatures of Directors)

____

____

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 4:E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

Forms

[Form 4:E] Draft Organizational Minutes

MINUTES OF FIRST MEETING

OF

BOARD OF DIRECTORS

OF

ABC COMPANY, INC.

The directors of the above corporation held their first meeting on *(date)*, at *(place)*, commencing at *(time)*. The meeting was held pursuant to a Waiver of Notice and Consent signed by each of the Directors, which has been placed in the Minute Book preceding these minutes.

The following Directors, constituting a quorum of the Board of Directors named *(in the Articles of Incorporation, or by the Incorporator(s))*, were present:

....
....
....

Absent were: ....

Also present were: *(e.g., legal counsel)*

Upon motion duly made, seconded and unanimously carried, ___________ was elected Chairperson of the meeting and ___________ was elected Secretary of the meeting.

The Chairperson stated that the Articles of Incorporation of the Corporation were filed in the office of the California Secretary of State on *(date)*. The Chairperson presented to the meeting a certified copy of the Articles of Incorporation and the Secretary was directed to insert the copy in the Minute Book of the Corporation.

The meeting proceeded to the completion of the organization of the corporation, and, upon motion duly made, seconded, and unanimously carried, the following resolutions were adopted:

RESOLVED: That ____________, named as this corporation's initial agent for service of process in the Articles of Incorporation, is hereby confirmed in such capacity.

RESOLVED FURTHER: That the Bylaws presented to this meeting be, and the same hereby are, adopted as and for the bylaws of this corporation, and the Secretary is directed to certify the adoption of said Bylaws and to maintain a copy of the Bylaws, so certified, at the corporation's principal office in California in accordance with Section 213 of the California General Corporation Law.

RESOLVED FURTHER: That the corporate seal in the form, words, and figures presented to this meeting and impressed upon the last page of these minutes, be, and it hereby is, adopted as the seal of this corporation.

RESOLVED FURTHER: That the form of stock certificate(s) presented to this meeting be, and it hereby is, approved and adopted, and the Secretary is directed to insert a specimen certificate in the Minute Book immediately following these minutes.

RESOLVED FURTHER: That *(address)* be, and the same hereby is, designated and fixed as the principal office for the transaction of the business of this corporation.

ELECTION OF OFFICERS

The Chairperson stated the next item of business would be to elect officers of the corporation for the coming year. After discussion, and upon nominations duly made and seconded, the following persons were unanimously elected to the offices and at the annual salaries respectively set forth:

TITLE	NAME	SALARY
President		
Chief Financial Officer and Treasurer		
Secretary		

The directors thereupon unanimously adopted the following resolution:

RESOLVED: That the corporate officers are hereby directed to prepare and file with the California Secretary of State the Information Statement as required by Section 1502 of the California General Corporation Law.

FISCAL YEAR

The Chairperson stated it would be advisable for the corporation to establish a fiscal year. Upon motion duly made, seconded, and unanimously carried, the following resolution was adopted:

RESOLVED: That the fiscal year of this corporation shall end on *(date)* of each year.

ESTABLISH BANK ACCOUNTS

The Chairperson next proposed the Board make provision for the deposit of the funds of the corporation and their withdrawal. Upon motion duly made and seconded, the following resolutions were unanimously adopted:

[Insert bank-requested form resolutions]

PAYMENT OF INCORPORATION EXPENSES

In order to provide for the payment of the expenses of the incorporation and organization of the corporation, upon motion duly made, and seconded, the following resolution was unanimously adopted:

RESOLVED: That the officers of the corporation are authorized and directed to pay the expenses of its incorporation and organization, including effecting reimbursement to any persons who have advanced funds to the corporation for such purposes and payment of any amounts remaining owing to the corporation's attorney (and/or accountants) for services in connection therewith.

RATIFICATION OF PREINCORPORATION CONTRACTS

The board next considered the ratification of commitments made on behalf of the corporation prior to the completion of its organization. Upon motion duly made and seconded, the following resolutions were unanimously adopted:

RESOLVED: That the contracts and transactions entered into on behalf and for the benefit of this corporation, listed below, be and they hereby are accepted, adopted and ratified by this corporation:

[List contracts]

and

RESOLVED FURTHER: That this corporation save, defend, indemnify and hold harmless the persons who entered into said contracts and transactions on behalf and for the benefit of this corporation, from and against any liability or expense arising therefrom and thereunder.

AUTHORIZE BORROWINGS

The Chairperson stated the next matter for consideration was obtaining the corporation's initial funds and property for the commencement of its business. The Board was thereupon presented with the proposal of ____________ to loan the corporation $________ (and/or to transfer assets as described on the list attached to these Minutes) in consideration of the issuance of this corporation's debt securities upon specified terms and conditions. Upon motion duly made and seconded, the following resolutions were unanimously adopted:

RESOLVED: That it is in the best interests of this corporation to borrow the sum of $________ (acquire those certain assets described on the annexed list, the fair value of which in monetary terms is hereby determined to be $________).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

RESOLVED FURTHER: That the President and Secretary are hereby authorized and directed, on behalf and in the name of this corporation, to execute and deliver to ___________, its promissory note in the form attached to these Minutes, evidencing its obligation to pay the principal sum of $________ upon the terms and conditions set forth therein.

RESOLVED FURTHER: The officers, or any of them, are directed to comply with the California Corporate Securities Law of 1968 in connection with the issuance of said evidence of indebtedness.

AUTHORIZE ISSUANCE OF SHARES

The matter of issuing shares of the corporation's capital stock was then considered, and upon motion duly made and seconded, the following resolutions were unanimously adopted:

RESOLVED: That the officers of this corporation be, and they hereby are, authorized to sell and issue to the following persons the number of shares of capital stock of this corporation and for the consideration indicated opposite each name, for an aggregate of _____ shares, the consideration for which shares shall be ___________ Dollars ($________) per share, for an aggregate consideration of ___________ Dollars ($________);

NAME	**NUMBER OF SHARES**	**TYPE AND AMOUNT OF CONSIDERATION** *(e.g., $5,000 cash, or, Net Assets of a going business described in Appendix A attached valued at $5,000)*
___________		
___________		

[Where any of shares issued for noncash consideration:]

RESOLVED FURTHER: That the Board hereby determines the fair value to the corporation of the above-referenced noncash consideration to be received by it for the issuance of its shares of capital stock is not less than the amounts respectively set forth above.

RESOLVED FURTHER: That such shares shall be sold without the publication of any advertising or general solicitation.

[Where qualification required:]

RESOLVED FURTHER: That said shares shall be sold and issued only upon qualification therefor under the California Corporate Securities Law of 1968: the officers and directors of this corporation shall take such action as may be necessary or desirable to effect such qualification, and the corporation's shares shall be issued in accordance with the conditions thereof.

[Where exempt under Sec. 25102(f):]

RESOLVED FURTHER: That such shares shall be issued within the exemption from qualification afforded by Section 25102(f) of the California Corporate Securities Law of 1968 and shall, in all respects, meet the requirements thereof:

RESOLVED FURTHER: That each of the proposed issuees shall execute an investment representation with respect to the purchase of the securities of the corporation, and set forth therein their respective preexisting personal or business relationship with one or more of the corporation's directors or officers, or business or financial experience (or that of their professional

advisors who are not in any way affiliated with or compensated by this corporation or its agents) by reason of which they can reasonably be assumed to have the capacity to protect their own interests in connection with the transaction.

RESOLVED FURTHER: The officers and directors of this corporation shall cause to be prepared, executed and timely filed with the California Commissioner of Financial Protection and Innovation, a Notice in the form prescribed pursuant to Section 25102(f), and shall take such other further action as may be necessary or desirable to effectuate the foregoing resolutions.

[Where exempt under Section 25102(h)*:]*

RESOLVED FURTHER: That such shares shall be sold and issued without payment of selling expenses and within the exemption from qualification afforded by Section 25102(h) of the California Corporate Securities Law of 1968, and shall in all respects meet the requirements of that exemption.

RESOLVED FURTHER: That the officers and directors of this corporation be, and they hereby are, authorized and directed to cause to be prepared, executed (including the required opinion of this corporation's counsel), and timely filed with the California Commissioner of Financial Protection and Innovation, a Notice in the form prescribed pursuant to Section 25102(h), and to take such further action as may be necessary or desirable to effectuate the foregoing resolutions.

[Section 1244 Resolution:]

RESOLVED FURTHER: That this corporation is a small business corporation as defined in Section 1244 of the Internal Revenue Code, and that the shares of its capital stock to be sold and issued hereunder shall be sold and issued to the extent they qualify as such pursuant to Section 1244 of the Internal Revenue Code.

SUBCHAPTER S ELECTION

The matter of electing to be taxed pursuant to Section 1362(a) of the Internal Revenue Code was next considered, and upon motion duly made and seconded, the following resolutions were unanimously adopted:

WHEREAS, the directors of this corporation deem it appropriate for the corporation to elect to be a small business corporation pursuant to Section 1362(a) of the Internal Revenue Code and to be an “S” corporation for tax purposes.

RESOLVED: That this corporation hereby elects, pursuant to Section 1362(a) of the Internal Revenue Code, to be an “electing small business corporation” and to be taxed under the Internal Revenue Code Subchapter S, such election to be effective for the fiscal year commencing *(date)*.

RESOLVED FURTHER: That the officers of this corporation are hereby authorized and directed to prepare, cause to be executed and to be filed with the appropriate office of the Internal Revenue Service, IRS Form 2553 together with the statement of each shareholder consenting to the Subchapter S election (together with a similar consenting statement by each shareholder's spouse), on or before *(date)*, and to execute such documents and take such other action as they may deem necessary or desirable to make the Subchapter S election effective.

There being no further business to come before the meeting, upon motion duly made, seconded and unanimously carried, the meeting was adjourned.

/s/___________
Secretary
ATTEST:
/s/___________
Chairperson

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 4:F

The Rutter Group | July 2024 Update

California Practice Guide--Corporations

Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 4. Forming the Corporation

Forms

[Form 4:F] Notice of Bulk Sale

Recording Requested By And When Recorded Mail To	
Name	
Address	
Street	
City &	
State	
Escrow No.	Space Above This Line for Recorder's Use

NOTICE TO CREDITORS OF BULK SALE

(Secs. 6101-6111 U.C.C.)

Notice is hereby given to creditors of the within named seller(s) that a bulk sale is about to be made on personal property hereinafter described.

The name(s) and business address of the intended seller(s) are:

The name(s) and business address of the intended buyer(s) are:

That the property pertinent hereto is described in general as: materials, supplies, machinery, parts, equipment and inventory and is located at:

The business name used by the said seller(s) at said location is:

The bulk sale which is the subject of this notice is a partial acquisition of the assets of ____________, a California corporation, by ____________, a California corporation.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Said bulk sale shall be consummated on or after ___________ at the offices of ___________, at ___________, California. This bulk sale is subject to Section 6106.2 of the California Commercial Code. Claims of any creditor of said seller may be filed with said buyer at the address set forth above for buyer, Attention: ___________. The last day for filing claims is ___________, which is the last business day before the consummation date specified above.

So far as is known to said intended buyer(s) said intended seller(s) used the following additional business names and addresses within the three years last past: (if “none” so state.)

Dated: ___________

____

____

____

____

Intended Buyer(s)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 5-A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 5. Share Issuance:
Securities Law Considerations

A. Introduction

1. [5:2] Authorization for Issuance
   a. [5:3] Authorized capital
      (1) [5:4] Compare—issuance of debt securities
   b. [5:5] Authorized issuance
      (1) [5:6] Resolution of board of directors
      (2) [5:7] Compliance with securities laws
      (3) [5:8] Issuance
2. [5:9] Consideration for Share Issuance
   a. [5:11] Fully paid vs. partly paid shares
3. [5:12] Accounting for Share Issuance
4. [5:12.5] Attorney "Due Diligence" and Ethical Concerns
   a. [5:12.6] "Due diligence" obligation under federal securities law
      (1) [5:12.7] Attorneys ordinarily not § 11 "experts"
      (2) [5:12.7a] Attorneys undertaking "due diligence" or its equivalent
   b. [5:12.8] State law determines whether management's fraud precludes corporate recovery against attorney
      (1) [5:12.8a] *Caveat*—maintaining client confidences
      (2) [5:12.9] Comment—scope of due diligence
   c. [5:12.10] Caution—attorney's liability to *investors*
   d. [5:12.15] Attorneys representing public companies or companies with pending registration statements—duty to report securities violations
      (1) [5:12.16] Alternative procedure for issuer with legal compliance committee
      (2) [5:12.17] Attorney's failure to comply enforceable only by SEC

[5:1] This Chapter deals primarily with the *original* issuance of securities by a corporation, as distinguished from later sales or transfers. (For a discussion of transfer of outstanding securities, *see ¶ 6:574 ff.*)

At the federal level, primary emphasis is upon the Securities Act of 1933, 15 USC § 77a et seq. (the "1933 Act" or "SA"), although relevant portions of the Securities Exchange Act of 1934, 15 USC § 78a et seq. (the "1934 Act" or "SEA"), are also discussed.

At the state level, the discussion focuses upon the most significant provisions of the California Corporate Securities Law (Corps.C. § 25000 et seq.), which applies *concurrently* with federal law (except to the extent specifically preempted).

In planning for the corporation's issuance of shares, there are several preliminary matters to be considered in addition to compliance with federal and state securities laws:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1. [5:2] **Authorization for Issuance:** First of all, if shares are to be issued by a corporation, they must be authorized by its articles of incorporation (*see ¶ 4:28 ff.*), and the issuance of stock (or of debt convertible into shares) must be approved by resolution of the board of directors (*see ¶ 4:456*).

a. [5:3] **Authorized capital:** The articles of incorporation must authorize issuance of enough shares to cover those now proposed to be issued. If all the shares authorized have previously been issued and are still outstanding, no further shares can be issued until the articles are amended to authorize more shares.

(1) [5:4] **Compare—issuance of debt securities:** As opposed to *share* issuance, no special authority need appear in the articles of incorporation for the corporation to issue other types of securities; e.g., bonds, debentures, promissory notes, etc. (However, the articles may be drafted so as to *limit* the corporation's power to do so; see Corps.C. §§ 204(a)(6), 207(g); see also Corps.C. §§ 2603(a)(6), 2605(g) (SPCs).)

b. [5:5] **Authorized issuance:** Issuance is the process by which a corporation sells and delivers its authorized shares (or other securities). Issuance requires formal action by the board of directors (or by the shareholders where the articles give them the right to determine the consideration to be received for the shares, *¶ 4:102 ff.*)—namely, accepting an offer to purchase the corporation's shares.

(1) [5:6] **Resolution of board of directors:** As discussed at *¶ 4:457 ff.*, the board of directors must adopt a resolution covering the following matters:

• Authorizing the issuance of its shares or securities.

• Determining the consideration for which its shares are to be issued and the monetary fair value thereof (if issued for other than money) pursuant to Corps.C. § 409(a) and (e) (unless such right is reserved to the shareholders; see Corps.C. § 204(a)(8), *discussed at ¶ 4:102 ff.*).

• Directing designated corporate officers to issue and deliver appropriate share certificates or other securities upon receipt of the specified consideration, all in compliance with appropriate federal and state securities laws.

FORM: Resolution Authorizing Issuance of Shares Contained in Draft Organizational Minutes, *see Form 4:E*.

(2) [5:7] **Compliance with securities laws:** Following such board action, the corporation must comply with federal and state laws regulating the offer, sale and issuance of shares or securities, as discussed in this chapter.

(3) [5:8] **Issuance:** Only *after* full compliance with such state and federal laws are the share certificates or securities actually executed and delivered to the issuees. A share register is required to be kept, identifying each certificate issued, the name and address of the issuee and the number and class of shares issued. [See Corps.C. § 1500]

2. [5:9] **Consideration for Share Issuance:** As previously discussed, there are statutory limits on the *type* of consideration for which shares may be issued; basically, prohibiting issuance of shares for *future* services or *unsecured* promissory notes. [See Corps.C. § 409(a), *¶ 3:307*]

[5:10] There are really no limits, however, on the *amount* of consideration for which shares may be issued. Absent fraud, the board's determination of the value of the consideration to be received for the corporation's shares is *conclusive*. [See Corps.C. § 409(b), *¶ 3:318*] (Remember, however, that the articles may reserve to the *shareholders* the power to determine the consideration for which the corporation's shares may be issued; see Corps.C. § 204(a)(8), *¶ 4:102 ff.*; see also Corps.C. § 2603(a)(8) (SPCs).)

a. [5:11] **Fully paid vs. partly paid shares:** As discussed at *¶ 3:321*, the board may authorize issuance of shares which are not fully paid. But the share certificate must contain a legend stating that a balance is owed; and dividend rights are restricted on partly paid shares. There are also statutory provisions for protection of corporate creditors in such cases. [Corps.C. §§ 409(d), 410; *see ¶ 3:326*]

3. [5:12] **Accounting for Share Issuance:** In earlier years, if shares were issued for more than their "par" value, the issuance resulted in "paid in surplus" or "capital surplus" (i.e., the excess above par value was shown in the surplus account). But California law has abolished any distinction between "par" and "no-par" value shares (*see ¶ 4:47*). Consequently, there is no need or justification for separate capital and surplus accounts when issuing shares. All of the consideration received for the shares is simply credited to a "capital" or "capital shares" account at whatever value is determined by the board of directors.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[5:12.1 - 5:12.4] ***Reserved.***

4. [5:12.5] **Attorney "Due Diligence" and Ethical Concerns:** Securities counsel, like attorneys in other fields, owe their clients a *duty of due care* in the performance of their professional services. If the corporation becomes liable to investors for damages arising from misrepresentations or omissions made in connection with an offering, the attorney may in turn be liable to the corporation for failing to prevent the deficient disclosure.

The appropriate standard of "due care" to be exercised by counsel in connection with securities offerings is determined by reference to *state law* governing *professional malpractice;* i.e., whether securities counsel breached their duty of "due care" is *not* a question of federal securities law. [See *O'Melveny & Myers v. Federal Deposit Ins. Corp.* (1994) 512 US 79, 87-89, 114 S.Ct. 2048, 2055-2056, *discussed at ¶ 5:12.8*]

a. [5:12.6] **"Due diligence" obligation under federal securities law:** Under SA § 11, only directors, underwriters and certain "experts" have a "due diligence" obligation. As explained below (¶ 5:12.7), attorneys generally are not "experts" in this context; nonetheless, they may assist directors or underwriters in the performance of "due diligence" in connection with the preparation of a registration statement.

(1) [5:12.7] **Attorneys ordinarily not § 11 "experts":** Directors, underwriters and "experts," such as accountants and engineers, may avoid liability under SA § 11 for deficient disclosures by affirmatively proving they had, "*after reasonable investigation*, reasonable ground to believe" the registration statement (or, in the case of experts, their "expertised" portions of the statement) contained no material errors or omissions (*¶ 5:61*). [SA § 11(b)(3) (15 USC § 77k(b)(3)) (emphasis added); see SA § 12(a)(2) (15 USC § 77*l*(a)(2))—"reasonable care" standard for avoiding liability as security seller]

On the other hand, except for *formal legal opinions* on specialized legal topics (e.g., tax) rendered in connection with an offering, attorneys are *not* "experts" under the 1933 Act and the registration statement is *not* "expertised" by them. Thus, the § 11 "due diligence" obligation does not apply directly to attorneys. [See *Escott v. BarChris Const. Corp.* (SD NY 1968) 283 F.Supp. 643, 683]

(2) [5:12.7a] **Attorneys undertaking "due diligence" or its equivalent:** Directors and other corporate personnel frequently expect counsel to assist them in the performance of their requisite "due diligence" investigation. And though the issuer cannot invoke a "due diligence" defense (*see ¶ 5:61*), an attorney's lack of *due care* in representing the issuer could result in a malpractice claim. For these reasons, attorneys have traditionally looked to § 11 for guidance in assisting clients with their due diligence obligations, and cases arising under § 11 may prove useful in delineating the scope of that assistance. [See, e.g., *In re Software Toolworks, Inc. Secur. Litig.* (ND CA 1992) 789 F.Supp. 1489, 1497-1511 (detailing underwriters' and accountants' "due diligence" investigation performed in public offering), aff'd in part and rev'd in part (9th Cir. 1994) 50 F3d 615]

b. [5:12.8] **State law determines whether management's fraud precludes corporate recovery against attorney:** In preparing any "disclosure document" and in otherwise complying with securities laws, counsel frequently use information supplied by management without independently verifying its accuracy. Federal law does *not* govern the potential liability of attorneys where management knowingly furnished counsel with false information. Like other issues involving breach of the attorney's duty of due care, whether the deliberate fraud of corporate personnel acting against the corporation's interest may be imputed to the corporation, thereby estopping the corporation from suing its attorneys for malpractice, is a question of *state* law. [*O'Melveny & Myers v. Federal Deposit Ins. Corp.* (1994) 512 US 79, 84-85, 114 S.Ct. 2048, 2053 (remanded to determine whether California law imputes management's knowledge to corporate victim of attorney negligence)]

(1) [5:12.8a] ***Caveat—maintaining client confidences:*** Corporate counsel has a duty to preserve client confidences and secrets (see Bus. & Prof.C. § 6068(e)—attorney must "maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client"). Thus, an attorney may *not* avoid potential securities liability by disclosing client confidential information. If confronted with a client who refuses to disclose all material information, the attorney may have no choice but to *withdraw* from legal representation. [See CRPC 1.13(b)-(d), 1.16 (formerly CRPC 3-600(B), (C), 3-700) (counsel's ethical duties when representing organization and circumstances justifying or mandating withdrawal from representation); *see also ¶ 5:12.15*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cross-refer: For a detailed discussion of attorney withdrawal from legal representation under the California Rules of Professional Conduct, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 10.

(2) [5:12.9] **Comment—scope of due diligence:** For the reasons discussed above (¶ 5:12.5 ff.), there is no authority setting forth the specific tasks counsel is expected to perform when assisting clients in the preparation of a registration statement and in the performance of the clients' "due diligence" obligations. The scope of counsel's activities varies with the type of offering and the degree of required disclosure. A registered public offering will entail exhaustive investigation and extensive disclosure in the form of a prospectus; issuance of stock in a small business to a few insiders may require little or even no "due diligence" or written disclosure.

The extent of the attorney's services will be a function of the client's sophistication and the extent to which the client (or the underwriter) assumes responsibility for drafting portions of the disclosure document (e.g., description of the business, industry in which the issuer operates, the competitive environment for its products/services). On the other hand, unsophisticated clients may rely heavily upon counsel to draft the offering document and to conduct factual investigation appropriate for such disclosure. In either instance, it is important for counsel to impress upon the client that the issuer and its executive officers and directors are ultimately responsible for the contents of the disclosure document, and that counsel's role is advisory.

c. [5:12.10] **Caution—attorney's liability to *investors:*** Attorneys representing a securities issuer (or other seller) may be liable for material misrepresentations or omissions contained in opinion letters or other communications that the attorneys make directly to investors in connection with a securities sale. *See* ¶ *5:421.2 ff., 6:368.5b*.

[5:12.11 - 5:12.14] *Reserved.*

d. [5:12.15] **Attorneys representing public companies or companies with pending registration statements—duty to report securities violations:** Under the SEC's Standards of Professional Conduct (17 CFR § 205.1 et seq.), an attorney representing an issuer that is either a 1934 Act reporting company or a company with a pending registration statement (*see* ¶ *5:54 ff.*) owes their professional and ethical duties to *the issuer as an organization*, rather than the issuer's officers, directors or employees. The attorney must report, to the chief legal officer and/or the chief executive officer, evidence of a material securities law violation, breach of fiduciary duty or similar violation by the issuer or any of its agents. [17 CFR §§ 205.2, 205.3(a),(b)(1); see SEC Rel. No. 33-8185 (2003)]

If the attorney reasonably believes it would be futile to report the evidence to these persons, or if the attorney fails to receive an appropriate response, the attorney must report "up the ladder" to the issuer's audit committee, another committee of independent directors, or the full board. [17 CFR § 205.3(b)(3), (4)]

(1) [5:12.16] **Alternative procedure for issuer with legal compliance committee:** An issuer may establish a "qualified legal compliance committee" comprised of no fewer than two independent directors (at least one of whom is a member of the audit committee) having the authority *and responsibility* to investigate and (if necessary) report a material violation of securities or similar law (¶ 5:12.15) to the full board and the SEC. An attorney representing an issuer with such a committee need report a violation *only to the committee*, and is not required to take any further action. [17 CFR §§ 205.2(k), 205.3(c)]

(2) [5:12.17] **Attorney's failure to comply enforceable only by SEC:** An attorney's failure to comply with the SEC Standards may result in SEC proceedings seeking money penalties and/or injunctive relief, including prohibiting the attorney from practicing before the SEC (a disastrous consequence for securities lawyers). However, the failure does *not* give rise to a private right of action against the attorney. [SEA § 4C (15 USC § 78d-3); 17 CFR §§ 205.6, 205.7]

[5:12.18 - 5:12.24] *Reserved.*

➪ [5:12.25] ***PRACTICE POINTER:*** Standard malpractice insurance typically *excludes* coverage for liability arising from securities work. Securities coverage is usually obtained through a separate rider, which often elicits detailed information on the applicant's practice and "due diligence" procedures. Attorneys not regularly engaged in securities work should check their malpractice coverage to ensure their work is consistent with any representations made to the carrier.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 5-B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 5. Share Issuance:
Securities Law Considerations

B. Federal Securities Law Requirements

- 1. [5:13] Introduction
  - a. [5:16] Securities Act of 1933—in general
    - (1) [5:17] Compare—Securities Exchange Act of 1934
    - (2) [5:18] Enforcement by SEC
  - b. [5:18.5] Preemption of state law
    - (1) [5:18.6] Preempted securities and/or transactions
      - (a) [5:18.7] Notice filings under state law
        - 1) [5:18.8] State filing fees
      - (b) [5:18.9] California conformity to federal law
    - (2) [5:18.10] Compare—no preemption of state "antifraud" laws
- 2. [5:19] Registration Requirement
  - a. [5:20] "Interstate commerce"
    - (1) [5:21] Broadly interpreted
      - (a) [5:22] Limited application to foreign offers
    - (2) [5:24] Effect—nearly all transactions covered
    - (3) [5:25] Compare—California statute
  - b. [5:26] "Offer to sell"
    - (1) [5:27] Broadly interpreted
    - (2) [5:28] SEC Rule 135
  - c. [5:29] "Sale"
    - (1) [5:30] Again, broadly interpreted
    - (2) [5:31] Compare—California statute
  - d. [5:32] "Security"
    - (1) [5:32.1] "Stock" as securities
      - (a) [5:32.2] Characteristics of common stock
      - (b) [5:32.3] Label as "stock" not determinative
      - (c) [5:32.4] "Sale of business doctrine" not applicable
      - (d) [5:32.10] Stock *options* as securities
    - (2) [5:33] "Investment contracts" and "certificates of participation"
      - (a) [5:34] Test
      - (b) [5:35] "Common enterprise"—horizontal vs. vertical commonality
        - 1) [5:35.1] "Horizontal commonality" (more than one investor required)
        - 2) [5:35.2] "Strict vertical commonality"

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- a) [5:35.3] Compare—“broad” vertical commonality
- (c) [5:35.7] Expectation of “profits”
- (d) [5:36] “Efforts of others”; active vs. passive investors
  - 1) [5:37] “Risk capital” test
  - 2) [5:38] Compare—California law
  - 3) [5:39] Comment
- (3) “Notes” as securities
  - (a) [5:39.1] Short-term notes
    - 1) [5:39.2] Limited to prime commercial paper
    - 2) [5:39.2a] Compare—demand notes
  - (b) [5:39.3] Long-term notes
    - 1) [5:39.5] Four “resemblance” factors
      - a) [5:39.5a] Rationale for transaction
      - b) [5:39.5g] Manner of distribution
      - c) [5:39.5h] Investors' reasonable expectations
      - d) [5:39.5i] Existence of risk-reducing factors
        - 1/ [5:39.6] State regulation not adequate
  - (c) [5:39.6d] Compare—private, negotiated agreements
  - (d) Compare—California law
    - 1) [5:39.7] Short-term notes
    - 2) [5:39.8] Long-term notes
    - 3) [5:39.9] Convertible notes
- (4) Partnership, joint venture and LLC
  - (a) [5:40] General partnerships and joint ventures
    - 1) [5:40.1] Three-prong approach
      - a) [5:40.2] Agreement does not confer control rights
      - b) [5:40.3] Investor incapable of exercising control rights
      - c) [5:40.4] Business dependent on unique abilities of others
        - 1/ [5:40.5] Comment
    - 2) Application
  - (b) [5:41] Limited partnerships
  - (c) [5:41.1] LLC memberships
- (5) [5:41.6] Offerings of “cybercurrency” and other “digital assets”
- (6) [5:42] Exempt securities
  - (a) [5:43] Preemption of state law; California exemptions
  - (b) [5:44] Caution—antifraud rules still apply
- 3. [5:45] Registration Procedure
  - a. [5:46] Registration statement
    - (1) [5:47] Contents
    - (2) [5:48] Key disclosures in prospectus
      - (a) [5:48.1] “Plain English” requirement
    - (3) [5:49] Registration statement forms
  - b. [5:54] Filing and effective date
    - (1) [5:54.1] Exception for preregistration communications to certain institutional investors or by “Well-Known Seasoned Issuers”
    - (2) [5:55] Waiting period
    - (3) [5:56] Effective date
      - (a) [5:56.1] Delaying amendment
    - (4) [5:56.5] Effective only for offering properly covered thereby

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(5) [5:56.6] Subsequent periodic reports required
4. [5:57] Enforcement Provisions
a. [5:57.1] Extraterritorial application
b. [5:58] Civil liability for misstatements or omissions in registration statement (SA § 11)
(1) [5:58a] Determined at time registration statement became effective
(2) [5:58.1] "Materiality" limitation
(a) [5:58.1d] SEC-mandated disclosures presumed material
(b) [5:58.1e] Financial "materiality" not solely quantitative
(c) [5:58.2] Statements of opinion
1) [5:58.2a] Omission of fact; misleading statement
2) [5:58.3] Forecasts
3) [5:58.4] Proxy statements
(3) [5:59] Who may sue; tracing requirement
(a) [5:59.1] Comment—impact of tracing requirement
1) [5:59.2] Example
(b) [5:59.3] Applies to secondary market purchasers
(c) [5:59.5] Surviving corporation in merger has no § 11 claim
(d) [5:59.6] Unregistered shares in direct listing
(4) [5:60] Who may be held liable
(a) [5:60.1] Scienter not required
(b) [5:61] "Due diligence" defense
(5) [5:62] Scope of liability
(a) [5:62a] No "benefit-of-the-bargain" damages
(b) [5:62b] "Loss causation" defense as limitation on liability
(c) [5:62e] Apportionment of liability
1) [5:62.1] Contribution and indemnification among defendants
2) [5:62.1a] Outside director's liability
a) [5:62.1b] Exception for uncollectible judgments
(d) Attorney fees and costs
1) [5:62.2] Meritless claims
a) [5:62.2a] No attorney liability
b) [5:62.3] Fee-shifting among multiple claims
2) [5:62.4] Mandatory FRCP 11 sanctions
a) [5:62.5] Attorney fees and costs as presumptively proper sanction
(6) [5:63] One-year/three-year statute of limitations
(a) [5:63a] Three-year period not tolled
(b) [5:63b] One-year period commenced by "inquiry notice"?
(7) [5:63.1] Heightened pleading standards where complaint sounds in fraud
(a) [5:63.2] Complaints based on statements of opinion
(8) [5:64] Additional liability under Rule 10b-5
(9) [5:64.5] Federal preclusion ("preemption") of state law class actions
c. [5:65] Civil liability for "fraud" in connection with registered offering (SA § 12(a)(2))
(1) [5:65.1] Misleading statements and "half-truths" actionable
(a) [5:65.2] No plaintiff's duty to investigate
(2) [5:65.5] "Materiality" limitation
(3) [5:66] Who may sue—direct purchasers only
(a) [5:66.1] "Reliance" not part of prima facie case
(b) [5:66.2] Compare—Rule 10b-5
(4) [5:67] Who may be held liable

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [5:68] Privity of contract required
(b) [5:68.1] Who are "sellers"
1) [5:68.2] Comment
(c) Defenses
1) [5:69] Defendant's lack of knowledge
2) [5:70] Plaintiff's knowledge
a) [5:70a] Compare—no imputed knowledge (contributory negligence) defense
3) [5:70d] No loss causation
4) [5:70.1] "In pari delicto" defense
(5) [5:71] Scope of liability
(a) [5:71.1] No offset for tax benefits upon rescission
1) [5:71.2] Delay as bar to rescission?
2) [5:71.3] Compare—damages claims
(b) [5:71.4] Contribution and indemnification among defendants
1) [5:71.5] Indemnification claims
2) [5:71.6] Contribution claims
a) [5:71.7] Comment
3) [5:71.8] Preemption of state laws
(c) [5:71.9] No statutory attorney fees
1) [5:71.10] Fee-shifting by agreement
(6) [5:72] One-year/three-year statute of limitations
(a) [5:72.1] Three-year period—no "integration" of sales
(b) [5:72.2] Three-year period not tolled by fraudulent concealment
(c) [5:72.5] One-year period commenced by "inquiry notice"?
(d) [5:72.6] *Two*-year/*five*-year limitations period applicable?
(7) [5:73] Additional liability under Rule 10b-5
(8) [5:73a] Federal preclusion ("preemption") of state law class actions
d. [5:73.1] Civil liability for selling unregistered securities (SA § 12(a)(1))
(1) [5:73.2] Who may be held liable
(a) [5:73.2a] Compare—SEC enforcement actions
(2) [5:73.3] Strict liability for violations
(a) [5:73.3a] "In pari delicto" defense may prevent recovery
(3) [5:73.4] Measure of damages
(4) [5:73.5] Statute of limitations
(a) [5:73.6] No equitable tolling
e. [5:73.7] Concurrent federal/state court jurisdiction over 1933 Act claims
f. [5:73.8] Release of securities law claims
(1) [5:73.9] Exception for *postdispute* release
g. [5:74] Liability for fraudulent securities transactions (SA § 17)
(1) [5:74.1] SEC enforcement actions and criminal prosecution
(a) [5:74.2] Disgorgement
1) [5:74.3] Factors restricting disgorgement awards
(2) [5:75] No implied civil liability
(3) [5:75.1] Five-year limitations period on action seeking civil penalties
(4) [5:75.1a] Right to jury trial in SEC enforcement actions
h. [5:75.2] Compare—statutory bar to civil RICO liability
i. [5:75.13] Predispute arbitration agreements
(1) [5:75.14] Contract principles govern
(2) [5:75.14c] Enforcement by nonsignatory

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(3) [5:75.15] Scope of arbitrable issues
(4) [5:75.16] Self-regulatory organizations' response
(5) [5:75.18] Collateral estoppel and res judicata effect of arbitration award
(a) [5:75.19] Burden of proof
(b) [5:75.20] Application
(6) [5:75.25] Compare—customer's right to arbitrate dispute with broker, dealer or underwriter
5. Exemptions From Federal Registration Requirement
a. Introduction—importance of finding an exemption
(1) [5:76] Time and cost of registration
(2) [5:77] Potential liabilities in connection with registration statement or prospectus
(a) [5:78] Caution—Rule 10b-5 antifraud provisions still applicable
(3) [5:79] Potential liability for selling unregistered securities
(a) [5:80] Comment
b. [5:81] Intrastate offerings exemption (Rules 147 and 147A)
(1) [5:82] Issuer qualifications
(a) Issuer's "residence"
1) [5:83] Rule 147 requirements
2) [5:83.1] Rule 147A requirements
(b) [5:84] "Doing business"
(2) [5:89] Issuee qualifications
(a) [5:90] "Residence"
1) [5:91] Business entities
2) [5:91.1] Trusts
a) [5:91.2] Comment
(b) [5:92] Written representations re "residence"
(3) [5:94] Integration of offerings—"safe harbors"
(4) [5:97] No restriction on use of interstate commerce facilities
(a) [5:97.1] Rule 147A—general solicitation expressly permitted
(5) [5:98] Resale restrictions
(a) [5:100] Precautions against interstate sales
(b) [5:104] Compare—Rule 144 resale limitations inapplicable to public offerings
(6) [5:105] No report to SEC required
c. [5:106] "Crowdfunding" ($5 million) exemption (SA § 4(a)(6); Regulation Crowdfunding Rule 100 et seq.)
(1) [5:106.1] $5 million maximum
(a) [5:106.2] Aggregated with crowdfunding offerings by commonly-controlled entities
(b) [5:106.3] Integration with other exempt offerings
(2) [5:106.4] Issuer requirements
(3) [5:106.5] Limit on non-accredited investor's total crowdfunding purchases
(a) [5:106.6] "Annual income" and "net worth"
(b) [5:106.8] Spouses counted as one
(c) [5:106.9] Non-natural persons
(d) [5:106.10] Reliance upon funding intermediary
(4) [5:106.11] Dollar amounts indexed to inflation
(5) [5:106.12] Disclosure requirements
(a) [5:106.13] Financial statements
1) [5:106.14] Aggregation of prior offerings
2) [5:106.15] Contents; GAAP required
(b) [5:106.16] Amendments and updates
(c) [5:106.16a] "Testing the waters" materials (Rule 206)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) [5:106.16b] Before filing offering statement only
2) [5:106.16c] Must include legends
(6) [5:106.17] Annual report
(a) [5:106.18] Contents
(b) [5:106.19] Amendments
(c) [5:106.20] When report requirement terminates
(7) [5:106.21] “Bad actor” disqualification
(a) [5:106.22] “Covered persons”
(b) [5:106.23] Disqualifying acts
1) [5:106.23a] Felony and misdemeanor convictions
2) [5:106.23b] Injunctions or court orders
3) [5:106.23c] Final orders from government regulators
4) [5:106.23d] SEC suspension, revocation, limitation or ban
5) [5:106.23e] SEC cease-and-desist orders
6) [5:106.23f] Suspension or expulsion from national securities exchange or association
7) [5:106.23g] Statement subject to refusal order, stop order or suspension order
8) [5:106.23h] Mail fraud
(c) [5:106.24] Waiver by SEC
(8) [5:106.25] No advertising
(9) [5:106.26] Transfer restrictions
(10) [5:106.27] Licensed funding intermediary required
(a) [5:106.28] Disclosure and “due diligence” requirements
(b) [5:106.29] Limitation on ownership interest in issuer
(11) [5:106.31] Effect of failure to strictly comply with crowdfunding rules—“insignificant deviations”
(12) [5:106.32] Preemption of state crowdfunding provisions
(13) [5:106.33] 1934 Act registration ordinarily not required
(14) [5:106.34] Liability for material misstatements or omissions
(a) [5:106.35] Scope of recovery
(b) [5:106.36] Who may be liable
(c) Defenses
1) [5:106.37] Defendant's lack of knowledge
2) [5:106.38] Plaintiff's knowledge
3) [5:106.39] No causation between misstatement and loss
(d) [5:106.40] One-year/three-year statute of limitations
(e) [5:106.41] Liability subject to SA §§ 12 and 13
d. [5:107] Reg. D, Rule 504 ($10 million) exemption
(1) [5:110] Issuer qualification
(a) [5:110.1] “Bad actor” disqualification
(2) [5:111] Size of offering
(a) [5:111.1] “Aggregated” offering price
1) [5:112] Caution—“continuous” offerings
(b) [5:113] Sales made under other exemptions
(c) [5:114] Integrated offerings (Rule 152); offerings treated as one
1) [5:115] Rule 152's general principle; “facts and circumstances” standard
a) [5:115.1] Application to exempt offering prohibiting general solicitation
b) [5:115.2] Application to exempt offerings permitting general solicitation
2) [5:116] Safe harbors
a) [5:116.1] More than 30 days (Rule 152(b)(1))

b) [5:116.2] Rule 701, employee benefit plan or offshore (Regulation S) offerings (Rule 152(b)(2))
c) [5:116.3] Subsequent registered offerings (Rule 152(b)(3))
d) [5:116.4] Offers or sales preceding exempt offerings permitting general solicitation (Rule 152(b)(4))
3) [5:117] Commencement of offerings (Rule 152(c))
a) [5:117a] Offerings relying on Rule 241
b) [5:117b] Offerings relying on SA § 4(a)(2), Regulation D, Rule 147, or Rule 147A
c) [5:117c] Offerings relying on Regulation A
d) [5:117d] Offerings relying on Regulation Crowdfunding
e) [5:117e] Registration statement
4) [5:117.1] Termination or completion of offerings (Rule 152(d))
a) [5:117.1a] Offerings relying on SA § 4(a)(2), Regulation D, Rule 147, or Rule 147A
b) [5:117.1b] Offerings relying on Regulation A
c) [5:117.1c] Offerings relying on Regulation Crowdfunding
d) [5:117.1d] Registration statement withdrawn, abandoned, etc.
e) [5:117.1e] Abandoned or ceased public selling efforts
(3) [5:118] Number and identity of offerees
(4) [5:119] Information to investors
(5) [5:121] Limitation on advertising or public solicitation
(a) [5:121a] What constitutes "general solicitation"
(b) [5:121.1] Exceptions
1) [5:121.2] Registration satisfied by California permit
(c) [5:121.6] Permitted offers/sales—"pre-existing, substantive relationship"
1) [5:121.7] "Pre-existing"
2) [5:121.8] "Substantive"
3) [5:121.9] Brokers' advantage over issuers
(d) [5:121.10] "Demo days" and similar events (Rule 148)
1) [5:121.11] Events covered by "demo day" exemption
2) [5:121.12] Restrictions
a) [5:121.12a] No advertising
b) [5:121.12b] No sponsor recommendations, negotiations, fees or compensation
c) [5:121.12c] Limitation on information communicated
d) [5:121.12d] Online participation limitations
3) [5:121.13] "Angel investor group" defined
(e) [5:121.14] Generic solicitation of interest exemption (Rule 241)
1) [5:121.14a] No further solicitation until exemption determined
2) [5:121.14b] Conditions
a) [5:121.14c] No specific exemption determined
b) [5:121.14d] No money or compensation
c) [5:121.14e] No offer can be accepted
d) [5:121.14f] No obligation or commitments
(f) [5:121.15] Other methods of avoiding general solicitation
1) [5:121.16] Investor networks
(g) Examples
(h) [5:121.30] Dissemination of factual information
(6) [5:122] Brokerage commissions
(a) [5:122.1] Caution—state law/regulatory limitations
(7) [5:123] Resale restrictions

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [5:124] Issuer's responsibilities
(b) [5:124.5] Certain resales to "accredited" investors (§ 4(a)(7))
1) [5:124.6] State regulation preempted
2) [5:124.7] Private resales—"Section 4(a)(1-1/2) exemption"
(c) [5:125] SEC "safe harbor" resale rules
1) [5:126] Rule 144
a) [5:127] Resales by "affiliates"
b) [5:128] Resales by "nonaffiliates"
2) [5:130] Resales of restricted securities to institutional investors under Rule 144A
a) [5:130.1] "Qualified institutional buyer" defined
b) [5:131] Fraud/nondisclosure liability unaffected
(d) [5:133] Exception—Rule 504 "public" offerings
(8) [5:135.1] Effect of failure to strictly comply with Reg. D requirements—"insignificant deviations"
(a) [5:135.2] Limitation—no deviation from dollar ceiling or general solicitation requirements
(b) [5:135.3] Minor deviations still actionable by SEC
(9) [5:136] Form D filing required
(a) [5:137] Effect of failure to file
e. [5:171] Private placement exemption—no $ limit
(1) [5:172] Reg. D, Rule 506
(a) [5:173] Rule 506(b) offerings—sales to "accredited" investors and up to 35 "sophisticated" investors with no advertising or public solicitation
1) [5:173.1] General solicitation prohibited
a) [5:173.2] Permitted offers/sales—"pre-existing, substantive relationship"
b) [5:173.3] Other methods of avoiding general solicitation
c) [5:173.4] Dissemination of factual information
d) [5:173.5] "Demo days" and similar events
2) [5:174] "Accredited" investors defined
a) [5:174.1] Institutional investors
b) [5:174.2] Private business development companies
c) [5:174.3] Charities
d) [5:174.3a] Business entities
e) [5:174.4] Insiders
f) [5:174.5] Wealthy investors
g) [5:174.5a] Trusts
h) [5:174.6] Wholly-owned entities
i) [5:174.6a] Catch-all category
j) [5:174.6b] Certified professionals
k) [5:174.6c] Knowledgeable employees
l) [5:174.6d] Family offices
m) [5:174.6e] Family clients
3) [5:174.7] Compare—California rules
4) [5:174.11] Not more than 35 "sophisticated" ("nonaccredited") investors
a) [5:174.12] Spouses
b) [5:174.13] Controlled entities
c) [5:174.14] Entities
5) [5:175] Verifying investor qualifications
6) [5:176] "Purchaser representative"
a) [5:177] Qualifications
b) [5:178] Independent of issuer

c) [5:179] Disclosure to investor
7) [5:180] Compare—California rule
(b) [5:181] Rule 506(c) offerings—advertising and public solicitation permitted but sales limited to "accredited" investors
1) [5:181.1] "Safe harbor" verification methods for natural persons
a) [5:181.2] Income verification
b) [5:181.3] Net worth verification
c) [5:181.4] Alternative—verification by professional
d) [5:181.4a] Certification (pre-9/23/13)
e) [5:181.4b] Written representation
2) [5:181.5] Relationship between "reasonableness" of verification and method of offering
(c) Disclosure requirements
1) [5:182] Offerings to "nonaccredited" investors
a) [5:182.1] Reporting companies
b) Nonreporting companies
1/ [5:182.2] Nonfinancial information
2/ [5:182.3] Financial information
2) [5:182.4] Offerings to "accredited" investors
(d) [5:183] State regulation preempted
(e) [5:183.1] Integrated offerings
(f) [5:184] Resale restrictions and "safe harbor" rules
(g) [5:184.1] "Insignificant deviations" from requirements
(h) [5:184.2] "Bad actor" disqualification
(i) [5:185] Report of sale on Form D
1) [5:185.1] California filing requirement
a) [5:185.2] Filing by mail
b) [5:185.3] Filing electronically
c) [5:185.4] Restrictions on amended filings
1/ [5:185.5] "Cal-EASI" superseded by DOCQNET
(2) [5:186] Private placement exemption outside Rule 506 (SA § 4(a)(2) exemption)
(a) [5:187] Case law as to what constitutes "private" offering
(b) [5:188] SEC criteria
f. [5:189.1] Exemption for compensatory benefit plans (Rule 701)
(1) [5:189.2] Annual ceiling on securities sales
(2) [5:189.3] Resale restrictions
(3) [5:189.4] No integration with other offerings
(4) [5:189.5] No preemption of state law
g. [5:190] Regulation A "short form" registration for up to $75 million
(1) [5:190.1] Tier 1 offerings
(a) [5:190.2] No preemption of state regulation
(2) [5:190.3] Tier 2 offerings
(a) [5:190.4] Investor restrictions
1) [5:190.5] Reliance on investor representations
(b) [5:190.6] State securities laws preempted
1) [5:190.7] California notice filing required
a) [5:190.8] Annual filings; amendments
(3) [5:191] Issuer qualifications
(a) [5:191.1] "Bad actor" disqualification
(4) [5:191.2] Additional limit on secondary sales

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(5) [5:191.3] "Testing the waters" ("solicitation of interest") before preparing offering statement
(6) [5:192] Qualification process; disclosure requirements
(a) [5:192.1] Confidential filing of preliminary offering statements (first-time Reg. A issuers)
(b) [5:192.2] Required financial statements
(c) [5:192.3] Delivery of preliminary offering circular
(d) [5:192.4] Final offering circular—electronic delivery permitted
(e) [5:192.5] Delayed offerings
(7) [5:192.6] Post-qualification reporting requirements
(8) [5:192.7] Integration with other offerings
(9) [5:192.8] Effect of failure to strictly comply with Reg. A requirements—"insignificant deviations"
(a) [5:192.9] Limitation—no deviation from offering limitations or issuer qualifications
(b) [5:192.10] Minor deviations still actionable by SEC
(10) [5:193] Antifraud rules still apply
(11) [5:194] No resale limitations
(12) [5:194a] Permit by coordination
(13) [5:194b] Exemption from 1934 Act registration (Tier 2 issuers)
h. [5:194.1] Judicial or administrative approval upon fairness hearing (SA § 3(a)(10) exemption)
(1) [5:194.2] Requirements
(a) [5:194.3] Securities issued in exchange transaction
(b) [5:194.4] Fairness hearing
1) [5:194.5] Hearing and approval by Financial Protection and Innovation Commissioner
(2) [5:194.6] No resale restrictions
i. [5:194.11] Securities offerings in bankruptcy proceedings

1. [5:13] **Introduction:** The need to protect investors from unfair or fraudulent practices when securities are issued is recognized under both federal and state law. The offer, sale and issuance of corporate shares and other securities is deemed to affect both national and local economic interests, and therefore is subject to close regulation under both federal and state law.

[5:14 - 5:15] ***Reserved.***

a. [5:16] **Securities Act of 1933—in general:** The Securities Act of 1933 (15 USC § 77a et seq.) provides the framework of federal regulation of the issuance of securities. It applies generally to any sale of shares involving use of instrumentalities of *interstate commerce* (mail, telephone, email, etc.).

It provides for a *registration* system, the purpose of which is to assure *full and fair disclosure* of all material facts about the issuer and the shares being issued, so as to enable investors to make informed decisions regarding the investment. It also provides a number of important *exemptions* from the registration requirement. [See *Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund* (2015) 575 US 175, 178-179, 135 S.Ct. 1318, 1323; *Federal Housing Finance Agency v. Nomura Holding America, Inc.* (2nd Cir. 2017) 873 F3d 85, 98]

The basic provisions of the 1933 Act are summarized below (¶ 5:17 ff.).

(1) [5:17] **Compare—Securities Exchange Act of 1934:** The other major federal securities law is the Securities Exchange Act of 1934 (15 USC § 78a et seq.). The 1934 Act primarily regulates trading in securities that are already issued and outstanding, and therefore is beyond the scope of this chapter. However, the 1934 Act's antifraud disclosure requirements (e.g., § 10b) do apply to issuances, and are therefore equally as important as the registration requirements of the 1933 Act.

(2) [5:18] **Enforcement by SEC:** Both the 1933 Act and the 1934 Act are administered and enforced by the Securities and Exchange Commission (SEC).

[5:18.1 - 5:18.4] ***Reserved.***

b. [5:18.5] **Preemption of state law:** To avoid duplicative and unduly burdensome regulation by the states, the 1933 Act expressly preempts state regulation of certain nationally traded securities and securities issued in reliance on specified federal exemptions. [See SA § 18 (15 USC § 77r)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

On the other hand, in areas where there is no preemption, state securities laws also apply, and an issuer must comply with both the federal rules discussed in this section and additional California rules discussed at *¶ 5:195 ff.*

Where compliance with both federal and state law is required, the two regulatory schemes are designed to be complementary. Generally, *both* systems have:

- Substantive "antifraud" provisions (SA § 12(2) (15 USC § 77*l*), SEA § 10(b) (15 USC § 78j(b)) and SEC Rule 10b-5 (17 CFR § 240.10b-5), *¶ 6:360*; and Corps.C. § 25401, *¶ 5:390*);
- Registration or qualification requirements, including important *exemption* provisions (SA § 5 (15 USC § 77e), *¶ 5:42, 5:76 ff.*; Corps.C. § 25110 et seq., *¶ 5:195 ff.*).

(1) [5:18.6] **Preempted securities and/or transactions:** Most significantly, state laws requiring the qualification of securities or regulating the use of offering documents do *not* apply (except for any "notice filings" and accompanying fees, ¶ 5:18.7 ff.) to the following:

- *Securities* listed (or authorized for listing) on a national securities exchange (or tier or segment thereof) that is a member of the SEC-designated National Market System—e.g., the New York Stock Exchange, NYSE American, Nasdaq Global Market and Global Select Market—including debt instruments equal or senior to the listed securities;
- *Securities* issued by an investment company that is registered (or that has filed a registration statement) under the Investment Company Act of 1940;
- *Resales*—i.e., sales other than the original issuance by the issuer or by an underwriter or dealer (SA § 4(a)(1))—of securities previously issued by a 1934 Act reporting company;
- *Offers or sales* of securities made in reliance on the "crowdfunding" exemption (*¶ 5:106 ff.*);
- *Offers or sales* of securities on a national securities exchange in accordance with SEC rules (not yet adopted);
- *Offers or sales* of securities to "qualified purchasers," as defined by SEC rules (at present, the only such SEC rule is Rule 256, which applies to Reg. A, Tier 2 offerings; *see ¶ 5:190.6*); and
- *Offers or sales* of securities made in reliance on SEC Rule 506 (*¶ 5:172 ff.*) or such other SEC rules or regulations as may be issued in the future under the SA § 4(a)(2) private placement exemption (*see ¶ 5:171 ff.*). [SA § 18(a), (b), (d)(4) (15 USC § 77r(a), (b), (d)(4)); see SA § 4(a)(1), (a)(2) (15 USC § 77d(a)(1), (a)(2))]

(a) [5:18.7] **Notice filings under state law:** Federal preemption of state qualification requirements is absolute (i.e., states may *not* impose any filing or fee requirements) for (i) securities listed (or authorized for listing) on a national securities exchange (or tier or segment thereof) that is a member of the SEC-designated National Market System, such as the New York Stock Exchange, NYSE American, Nasdaq Global Market and Global Select Market, and (ii) securities equal or senior to any of these securities. [SA § 18(c)(2)(D) (15 USC § 77r(c)(2)(D))]

With respect to all other preempted securities/transactions, states may require the filing of a consent to service of process and the filing, solely for *notice* purposes, of any document that has been filed with the SEC. [SA § 18(c)(2)(A) (15 USC § 77r(c)(2)(A))]

1) [5:18.8] **State filing fees:** States may assess fees for any required filings. If a fee is not paid, a state may suspend the offer or sale of securities within the state. [SA § 18(c)(2), (3)(15 USC § 77r(c)(2), (3)); see Corps.C. § 25532(a), *discussed at¶ 5:429*]

(b) [5:18.9] **California conformity to federal law:** California law generally conforms to the federal preemption provisions—i.e., California expressly exempts federally preempted securities and transactions from state qualification requirements (though California imposes requirements relating to notice, consent to service and filing fees in some transactions). [See Corps.C. §§ 25100.1, 25101.1, 25102.1; Commr.Rel.No. 109-C (revised 2007); *see also ¶ 5:195.5 ff.*]

(2) [5:18.10] **Compare—no preemption of state "antifraud" laws:** The federal securities laws do *not* preempt state laws imposing liability for statutory or common law misrepresentation in connection with the purchase and sale of securities (¶ 5:390 ff.).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Nor do they preempt the power of state securities regulators to *investigate* and bring *enforcement actions* with respect to securities fraud or deceit. [SA § 18(c)(1) (15 USC § 77r(c)(1)); see *People v. Edward D. Jones & Co.* (2007) 154 CA4th 627, 637-639, 65 CR3d 130, 138-140; *Capital Research & Mgmt. Co. v. Brown* (2007) 147 CA4th 58, 68-69, 53 CR3d 770, 777]

2. [5:19] **Registration Requirement:** The 1933 Act forbids the use of interstate facilities or the mails to offer securities for sale unless the issuer has *filed* a registration statement; or to actually sell such securities until the registration statement has "become effective" (*see ¶ 5:56*). [SA § 5 (15 USC § 77e); see *Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund* (2015) 575 US 175, 178-179, 135 S.Ct. 1318, 1323]

a. [5:20] **"Interstate commerce":** The 1933 Act applies only to transactions involving the use of "any means or instruments of transportation or communication in interstate commerce or of the mails." [SA § 5(a)(1) (15 USC § 77e(a)(1))]

(1) [5:21] **Broadly interpreted:** The courts have interpreted this provision broadly. The requisite use of interstate commerce facilities exists if *any part* of the transaction was accomplished through use of such facilities. For example, mailing the offer or payment, or confirmation or other correspondence in connection with the transaction, subjects the transaction to federal securities law. [*Franklin Sav. Bank of New York v. Levy* (2nd Cir. 1977) 551 F2d 521, 524]

Even an *intrastate telephone call* is deemed to be a "facility utilized in interstate commerce," so as to render the transaction subject to the Act. [*Dupuy v. Dupuy* (5th Cir. 1975) 511 F2d 641, 644]

(a) [5:22] **Limited application to foreign offers:** But the registration requirements would probably not apply to a securities offering by a foreign (non-U.S.) issuer to persons outside the U.S. even if the offering involved means or instrumentalities of U.S. commerce; *see ¶ 5:57.1*.

[5:23] ***Reserved.***

(2) [5:24] **Effect—nearly all transactions covered:** Unless the share issuance transaction can be effected entirely within a single state, and without the use of the mail, email, telephone or any other facility of interstate communication, the issuance may be subject to federal registration requirements.

(3) [5:25] **Compare—California statute:** The California Corporate Securities Law applies only to offers or sales of securities "made in this State." [See Corps.C. § 25008; *¶ 5:195.1 ff.*]

b. [5:26] **"Offer to sell":** The 1933 Act applies to any "attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." [SA § 2(a)(3) (15 USC § 77b(a)(3))]

(1) [5:27] **Broadly interpreted:** Again, this provision is interpreted broadly. According to the SEC, an "offer to sell" includes any *activity* that, under the circumstances, can be found *intended to stir public interest* in a security (e.g., disseminating a news release with the purpose and effect of procuring or soliciting advance orders for share purchases). [*Matter of Carl M. Loeb, Rhoades & Co. and Dominick & Dominick* (1959) 38 SEC 843]

(2) [5:28] **SEC Rule 135:** Pursuant to authority granted by the 1933 Act, the SEC has promulgated a rule providing objective guidelines as to what information can be disseminated by news releases, etc., before shares are registered. The news release or other notice of a proposed registered offering must state that the notice does not constitute an offer of any securities for sale, and may include no more than the following:

• The name of the issuer;

• The title, amount and basic terms of the securities;

• The amount of any offering by selling security holders;

• The anticipated timing of the offering;

• A brief statement of the manner and purpose of the offering, without naming the underwriters; and

• Whether the issuer is directing its offering to only a particular class of purchasers. [SEC Rule 135 (17 CFR § 230.135); see *Chris-Craft Indus., Inc. v. Bangor Punta Corp.* (2nd Cir. 1970) 426 F2d 569, 574]

c. [5:29] **"Sale":** The 1933 Act covers any "sale or disposition of a security or interest in a security, for value." [SA § 2(a)(3) (15 USC § 77b(a)(3))]

(1) [5:30] **Again, broadly interpreted:** "Sale" has been interpreted as covering many transactions not normally thought of as sales: e.g., exercise of *conversion rights*, or of *options*, or *warrants* to buy or sell a security. But an *exchange* of securities between the issuer and its *existing* security holders (e.g., stock splits, recapitalizations) where no commission or other remuneration is paid for soliciting such exchange, is specifically exempt from the Act. [SA § 3(a)(9) (15 USC § 77c(a)(9))]

(2) [5:31] **Compare—California statute:** The California Corporate Securities Law is even broader than the federal statute in this area. It may apply even to *any change* in the rights, preferences, privileges or restrictions of outstanding shares. [Corps.C. § 25017(a); Commr. Rule 260.103; *see¶ 5:195.4a*]

d. [5:32] **"Security":** The 1933 Act applies not only to what is usually thought of as a "security" (e.g., stocks, bonds, debentures, promissory notes, etc.), but also to:

• "Investment contracts" or "certificates of interest or participation in any profit-sharing agreement"; and to

• "Guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." [SA § 2(a)(1) (15 USC § 77b(a)(1))]

Substantially identical definitions of a "security" are found in the 1934 Act and in the California Corporate Securities Law. [See SA § 3(a)(10) (15 USC § 77c(a)(10)); and Corps.C. § 25019; see also *SEC v. Edwards* (2004) 540 US 389, 393, 124 S.Ct. 892, 896—1933 Act and 1934 Act definitions of "security" are "slightly different formulations which we have treated as essentially identical in meaning"; *SEC v. Thompson* (10th Cir. 2013) 732 F3d 1151, 1158, fn. 5—"The Supreme Court has repeatedly ruled that the definitions of 'security' in § 3(a)(10) of the 1934 Act and § 2(1) of the 1933 Act are virtually identical, and should be treated as such in decisions dealing with the scope of the term" (internal quotation marks and citation omitted); *and¶ 5:41.1* re statutory standards for treating LLC interests as securities]

[5:32a] **Substance over form:** In determining whether a given investment constitutes a "security," courts look to the *substance* of a transaction rather than its form. If a transaction falls within the *regulatory purpose* of the securities laws (i.e., protecting the public from fraud), it will be governed by such laws even if it may not come within the technical definition of a "security." [*People v. Figueroa* (1986) 41 C3d 714, 735-736, 224 CR 719, 733-734; see *SEC v. Edwards* (2004) 540 US 389, 393-394, 124 S.Ct. 892, 896-897; *Reves v. Ernst & Young* (1990) 494 US 56, 60-61, 110 S.Ct. 945, 949]

(1) [5:32.1] **"Stock" as securities:** Interests in a corporation labeled as "stock" or "shares" which have the "usual characteristics of stock" (¶ 5:32.2) constitute a "security" within the federal securities laws. [*Landreth Timber Co. v. Landreth* (1985) 471 US 681, 693, 105 S.Ct. 2297, 2305; *Sulkow v. Crosstown Apparel Inc.* (2nd Cir. 1986) 807 F2d 33, 36; see *Stoyas v. Toshiba Corp.* (9th Cir. 2018) 896 F3d 933, 939-942—"stock" includes American Depositary Receipts (ADRs), which are negotiable certificates issued by U.S. depositary institution representing beneficial interest in shares of non-U.S. corporation]

(a) [5:32.2] **Characteristics of common stock:** The U.S. Supreme Court has identified the following significant characteristics "usually associated with common stock":

• Right to receive dividends contingent upon apportionment of profits;

• Negotiability;

• May be pledged or hypothecated;

• Voting rights conferred in proportion to number of shares owned; and

• Capable of appreciating in value. [*United Housing Found., Inc. v. Forman* (1975) 421 US 837, 851, 95 S.Ct. 2051, 2060]

(b) [5:32.3] **Label as "stock" not determinative:** However, corporate instruments labeled "stock," but which possess few or none of the above characteristics (¶ 5:32.2), do *not* constitute a "security" under the securities laws. [*United Housing Found., Inc. v. Forman* (1975) 421 US 837, 851, 95 S.Ct. 2051, 2060—shares in nonprofit cooperative housing corporation not a "security" within federal securities laws; see also *Seger v. Federal Intermediate Credit Bank of Omaha* (8th Cir. 1988) 850 F2d 468, 469]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(Note: *Preferred* stock may have different characteristics than those associated with common stock, and yet be covered by the federal securities laws; see *Landreth Timber Co. v. Landreth* (1985) 471 US 681, 686, 105 S.Ct. 2297, 2302, fn. 2.)

(c) [5:32.4] **"Sale of business doctrine" not applicable:** In the past, some courts found that the purchase and sale of a controlling stock interest in a going business was not subject to the federal securities laws where the purchaser intended to be "active" in control of the business. Although shares are involved, the arguable economic effect is the same as the direct purchase and sale of the assets of the business, which would not normally be subject to the securities laws.

[5:32.5] However, this "sale of business doctrine" does *not* apply to the sale of *traditional stock transferring control of a closely held business*. Since there is a purchase and sale of "securities," the federal securities laws apply. Rationale: The purchase of 50% or more of the outstanding stock may or may not provide "actual control" of the corporation (i.e., actual control may be determined by such factors as voting rights, veto rights, etc.); thus, such a "control test" would lead to uncertainty and inconsistent and arbitrary results. [*Gould v. Ruefenacht* (1985) 471 US 701, 704-706, 105 S.Ct. 2308, 2310-2311 (sale of 50% of stock); *Landreth Timber Co. v. Landreth* (1985) 471 US 681, 694-697, 105 S.Ct. 2297, 2306-2307 (sale of 100% of stock)]

[5:32.6 - 5:32.9] ***Reserved.***

(d) [5:32.10] **Stock *options as securities:*** An option to purchase stock is a security separate and apart from the underlying stock. This is so even where the option is not in writing—i.e., an *oral* option is a security. [SA § 2(a)(1) (15 USC § 77b(a)(1)); *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.* (2001) 532 US 588, 593-595, 121 S.Ct. 1776, 1780-1781]

(2) [5:33] **"Investment contracts" and "certificates of participation":** These terms are used as catch-alls to cover any common enterprise entered into with expectation of profits *primarily* from the efforts of others; i.e., *passive* investments.

(a) [5:34] **Test:** The traditional two-prong test for whether an interest is a "security" under the 1933 Act is whether the "person invests his money (1) in a common enterprise and (2) is led to expect profits *solely* from the efforts of the promoter or a third party." [*SEC v. W.J. Howey Co.* (1946) 328 US 293, 298-299, 66 S.Ct. 1100, 1103 (emphasis added)]

(b) [5:35] **"Common enterprise"—horizontal vs. vertical commonality:** The federal courts recognize two types of "common enterprise"—*horizontal* commonality and *vertical* commonality. Horizontal commonality clearly constitutes a "common enterprise" (see below, ¶ 5:35.1); but there is a split of authority whether (and what type of) vertical commonality might satisfy the *Howey* "common enterprise" test. The U.S. Supreme Court has thus far refused to resolve the question whether horizontal commonality is essential to the existence of a "common enterprise." [See *Mordaunt v. Incomco* (9th Cir. 1982) 686 F2d 815, 817]

1) [5:35.1] **"Horizontal commonality" (more than one investor required):** All courts agree a "common enterprise" within the meaning of *Howey* can be established by a showing of horizontal commonality—i.e., a *pooling of funds* received by a promoter from multiple investors with *each* individual investor's fortune tied to the other investors' fortunes (usually by the prorated distribution of profits, whether in the form of a fixed or variable rate of return). [See, e.g., *Stone v. Kirk* (6th Cir. 1993) 8 F3d 1079, 1085—"horizontal commonality requirement … means only that funds of two or more investors must go into a common pool from which all may benefit" (internal quotes omitted); *SEC v. Infinity Group Co.* (3rd Cir. 2000) 212 F3d 180, 187-191—horizontal commonality existed where promoters guaranteed repayment of principal and exorbitantly high fixed rate of return supposedly realized from use of investors' funds to make large-scale investments]

Conversely, there is *no* horizontal commonality where there is no pooling of funds or profits. Thus, e.g., a condominium investment was *not* a security where the purchasers had no rent pooling or other common arrangement and their profit or loss was entirely independent of the others'. [*Revak v. SEC Realty Corp.* (2nd Cir. 1994) 18 F3d 81, 88] Nor was there horizontal commonality from "time-share" purchasers' pooling of available weeks without a pooling of profits. [*Wals v. Fox Hills Develop. Corp.* (7th Cir. 1994) 24 F3d 1016, 1018-1019]

2) [5:35.2] **"Strict vertical commonality":** Some courts (including the Ninth Circuit) hold that a "common enterprise" also exists where the investor (even a *single investor*) shares risk *with the promoter(s)*. Such "vertical commonality" of investment risk does not require that the investors' fortunes rise and fall together based on a pro rata sharing of profits and losses. Instead, the investors' fortunes need only be tied to the *promoter's* fortune. (E.g., the promoter must receive a percentage of the income or otherwise share in the risks and profits of the venture.) [See

SEC v. R.G. Reynolds Enterprises, Inc. (9th Cir. 1991) 952 F2d 1125, 1134—investor's fortune must be "linked with those of the promoters, sellers, or some third party"; also see, e.g., *SEC v. Continental Commodities Corp.* (5th Cir. 1974) 497 F2d 516, 522; *McGill v. American Land & Exploration Co.* (10th Cir. 1985) 776 F2d 923, 925]

Indeed, even where the promoter's profit is fixed and assured (e.g., paid "up front" in commissions), and thus there is no sharing of profits, vertical commonality exists if promoter and investor share a risk of *loss*. [*SEC v. Eurobond Exchange, Ltd.* (9th Cir. 1994) 13 F3d 1334, 1340—although promoter's compensation was paid up front and hence no sharing of profits, common enterprise existed where investor's and promoter's avoidance of loss depended on promoter's "sound management and continued solvency"; *United States v. Carman* (9th Cir. 1978) 577 F2d 556, 563—"This risk of *loss* is sufficient to bring the transaction within the meaning of a security, even where the anticipated financial gain is fixed" (emphasis added)]

a) [5:35.3] **Compare—"broad" vertical commonality:** A few courts have also found a "common enterprise" where the investors' fortunes are linked only to the promoter's *efforts* (not to their fortune). Under this broader view, the investors' fortunes need not be tied either to each other (horizontal commonality) or to the promoter's fortune. [See *Long v. Shultz Cattle Co., Inc.* (5th Cir. 1989) 881 F2d 129, 140-141, rhng.den. with opn. (1990) 896 F2d 85 (also acknowledging this approach creates a significant overlap between *Howey'*s "common enterprise" and the "efforts of others" prongs)]

The Ninth Circuit has not adopted "broad" vertical commonality. [See *Brodt v. Bache & Co., Inc.* (9th Cir. 1978) 595 F2d 459, 461—commodity broker's control over client's discretionary investment account did not create a security; see also *SEC v. R.G. Reynolds Enterprises, Inc.* (9th Cir. 1991) 952 F2d 1125, 1130-1131 & fn. 5—*Brodt* distinguished on ground that investor and promoter here shared profits on percentage basis]

[5:35.4 - 5:35.6] ***Reserved.***

(c) [5:35.7] **Expectation of "profits":** "Profits" consist of an *economic return* on the original outlay. The return may be at either a *fixed or variable rate*, and may be in the form of either *capital appreciation* of the initial investment or participation in *earnings*. [*United Housing Found., Inc. v. Forman* (1975) 421 US 837, 852-853, 95 S.Ct. 2051, 2060-2061; *SEC v. Edwards* (2004) 540 US 389, 394-396, 124 S.Ct. 892, 897-898; see *SEC v. Feng* (9th Cir. 2019) 935 F3d 721, 729-730; *Warfield v. Alaniz* (9th Cir. 2009) 569 F3d 1015, 1021-1024]

In contrast, when a purchaser is motivated by a desire to *use or consume* the item purchased, the securities laws do *not* apply. [*United Housing Found., Inc. v. Forman*, supra, 421 US at 852-853, 95 S.Ct. at 2060-2061—shares in housing cooperative entitling purchasers to occupy housing unit not "securities" where purchasers' sole motivation was to obtain housing; compare *Teague v. Bakker* (4th Cir. 1994) 35 F3d 978, 987-989—"capital appreciation" may exist in form of discounted lodging privileges in vacation time-shares marketed with emphasis on profit potential]

(d) [5:36] **"Efforts of others"; active vs. passive investors:** The "efforts of others" requirement of the *Howey* test for a "security" (¶ 5:34) has been liberalized by lower federal court decisions expanding the definition of "investment contract" to reach even enterprises in which the investor is expected to take *some active role.* The Supreme Court appears to have sanctioned this expansion of the concept of "investment contract" by omitting the word "solely" from its restatements of the *Howey* test (¶ 5:34) [See *International Brotherhood of Teamsters, Chauffeurs, Warehousemen & Helpers of America v. Daniel* (1979) 439 US 551, 561, 99 S.Ct. 790, 797; *Robinson v. Glynn* (4th Cir. 2003) 349 F3d 166, 170]

The 1933 Act thus applies where "the efforts made by those *other than* the investor are the *undeniably significant* ones, those *essential managerial efforts* which affect the failure or success of the enterprise." [*SEC v. Glenn W. Turner Enterprises, Inc.* (9th Cir. 1973) 474 F2d 476, 482 (emphasis added); see also *SEC v. Scoville* (10th Cir. 2019) 913 F3d 1204, 1222; *SEC v. Belmont Reid & Co., Inc.* (9th Cir. 1986) 794 F2d 1388, 1390-1391]

1) [5:37] **"Risk capital" test:** Under this expanded approach, the test is whether persons other than the investor will be *primarily* responsible for management of the business. Thus, even though the investor takes *some* part in the enterprise, their investment may constitute a "security" if the funds or other property contributed are part of the "risk capital" for the initial development of the business, managed by others, and over which they have little or no control. (This is the so-called "risk capital" test.)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2) [5:38] **Compare—California law:** California courts employ both the "risk capital" and "*Howey*" tests. [See *Silver Hills Country Club v. Sobieski* (1961) 55 C2d 811, 814-815, 13 CR 186, 188; *People v. Figueroa* (1986) 41 C3d 714, 736-737, 224 CR 719, 734-735 & fn. 28; *People v. Black* (2017) 8 CA5th 889, 900, 214 CR3d 402, 411-412]

A transaction may involve a "security" in California if it satisfies *either* test. [*Moreland v. Department of Corporations* (1987) 194 CA3d 506, 512-513, 239 CR 558, 561-562; *see*¶ *5:195.3a ff.*]

3) [5:39] **Comment:** The U.S. Supreme Court has expressly declined to decide whether the "risk capital" test should be used in interpreting federal securities laws. [See *United Housing Found., Inc. v. Forman* (1975) 421 US 837, 857, 95 S.Ct. 2051, 2063, fn. 24]

Arguably, the Supreme Court acquiesces in the more liberal view: It has declared that the "touchstone" of the *Howey* test is "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the *entrepreneurial or managerial efforts of others*." [*United Housing Found., Inc. v. Forman*, supra, 421 US at 852, 95 S.Ct. at 2060 (emphasis added)]

Lower federal courts have applied this approach in determining whether investments that are *predominantly* passive should be treated as "securities." Thus, real estate ventures or even investments in personal property may constitute "investment contracts" or "certificates of participation" (i.e., "securities") if coupled with *lease-back* or *management agreements* dependent upon the skill, expertise or efforts of the seller or others. For example:

• purchase of cattle coupled with cattle-feeding consulting agreement (*Long v. Shultz Cattle Co., Inc.* (5th Cir. 1989) 881 F2d 129, 134-139, rhng.den. with opn. (1990) 896 F2d 85, 87-88);

• purchase of condominium with optional rental pool arrangement (*Hocking v. Dubois* (9th Cir. 1989) 885 F2d 1449, 1460-1461 (en banc); but see *Allison v. Ticor Title Ins. Co.* (7th Cir. 1990) 907 F2d 645, 649 (criticizing *Hocking*); compare *Salameh v. Tarsadia Hotel* (9th Cir. 2013) 726 F3d 1124, 1130-1132—no "security" where condominium purchase and rental management agreement not offered together as package);

• purchase of gold ore coupled with refining contracts (*SEC v. R.G. Reynolds Enterprises, Inc.* (9th Cir. 1991) 952 F2d 1125, 1133-1135);

• purchase of skin care and vitamin products "distributorship" in multilevel ("pyramid") marketing scheme (*Webster v. Omnitrition Int'l, Inc.* (9th Cir. 1996) 79 F3d 776, 781-785);

• purchase of interests in viatical settlements (payment of present value of life insurance policies to terminally ill insureds in return for assignment of policy benefits; *see*¶ *5:309.10*) (*SEC v. Mutual Benefits Corp.* (11th Cir. 2005) 408 F3d 737, 743-745; but see *SEC v. Life Partners, Inc.* (DC Cir. 1996) 87 F3d 536, 545-548—viatical settlements not investment contracts because investors looked primarily to promoters' *presale* efforts in selecting insureds and policies (criticized by *Reiswig v. Department of Corporationsfor State of Calif.* (2006) 144 CA4th 327, 340, 50 CR3d 386, 396, for holding presale promotional efforts do not satisfy "*Howey*" test)).

(3) "Notes" as securities

(a) [5:39.1] **Short-term notes:** Notes with a maturity not exceeding *nine months* are exempt from the federal securities laws. [SA § 3(a)(3) (15 USC § 77c(a)(3)); SEA § 3(a)(10) (15 USC § 78c(a)(10))]

1) [5:39.2] **Limited to prime commercial paper:** The exemption is not read literally to encompass all notes having a maturity of nine months or less. Rather, the exemption applies only to *commercial paper*—i.e., high-quality instruments used to fund current operations and sold only to highly sophisticated investors. [See *SEC v. J.T. Wallenbrock & Assocs.* (9th Cir. 2002) 313 F3d 532, 541; *SEC v. R.G. Reynolds Enterprises, Inc.* (9th Cir. 1991) 952 F2d 1125, 1128, 1131-1133—6-month notes bearing 20%-30% interest issued to numerous customers to cover losses in discretionary investment accounts not within exemption; see also *Reves v. Ernst & Young* (1990) 494 US 56, 70-71, 110 S.Ct. 945, 954 (raising but not deciding issue because demand notes in question not "short-term"; see ¶ 5:39.2a)]

2) [5:39.2a] **Compare—demand notes:** Notes payable "on demand" do not *necessarily* have short terms—i.e., their maturity may exceed nine months to the extent demand may be made thereafter. Accordingly, demand notes do *not*

ordinarily come within the statutory exclusion for short-term notes. [*Reves v. Ernst* & Young (1990) 494 US 56, 73, 110 S.Ct. 945, 955 (noting the result might be different where both parties clearly contemplate demand will be made within 9 months)]

(b) [5:39.3] **Long-term notes:** Under the "family resemblance" test adopted by the U.S. Supreme Court, every longer-term note or evidence of indebtedness is *presumed* to be a security *unless* it bears a *strong family resemblance* (based on four factors, ¶ 5:39.5) to notes that clearly do *not* constitute "securities" (e.g., home mortgages, notes in consumer financing transactions, unsecured bank "character" loans, short-term notes secured by receivables or other business assets, an open account indebtedness converted into a note, and notes for commercial bank loans for current business operations). [*Reves v. Ernst & Young* (1990) 494 US 56, 64-67, 110 S.Ct. 945, 950-952 (rejecting both the "investment vs. commercial" approach and *Howey* test as applied to notes); see also *SEC v. R.G. Reynolds Enterprises, Inc.* (9th Cir. 1991) 952 F2d 1125, 1131]

Any note that fails to bear a "strong family resemblance" to the above judicially-recognized categories of "nonsecurities," *and* has a maturity exceeding nine months, is a "security."

[5:39.4] ***Reserved.***

1) [5:39.5] **Four "resemblance" factors:** An issuer rebuts the presumption that the note in question is a security by showing the note bears a sufficiently strong resemblance to one of the notes on the judicially-recognized list of "nonsecurities" (¶ 5:39.3), or by persuading the court to add the disputed note as yet another category on the list. [*Reves v. Ernst & Young*, supra]

Whether the issuer is successful turns upon consideration of the following four factors:

a) [5:39.5a] **Rationale for transaction:** The *reasons* a "reasonable seller and buyer" would enter into the transaction in question must be examined.

If the seller's purpose is to raise risk capital for a business and the buyer is mainly interested in profits the note will generate, the instrument is likely to be a "security." But if the note is issued to facilitate purchase of a *minor* asset or consumer good, to help the issuer's cash flow, or to advance some other commercial or consumer purpose, it is less likely to be considered a "security." [*Reves v. Ernst & Young* (1990) 494 US 56, 66, 110 S.Ct. 945, 951]

• [5:39.5b] A note evidencing a commercial bank loan to a developer to finance one of its projects (i.e., "to finance current business operations") was held not to be a "security." [*First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., N.A.* (9th Cir. 1990) 919 F2d 510, 515-516]

• [5:39.5c] Loan participations are not "securities" when sold by a bank to other financial institutions for commercial purposes rather than as investments in the borrowers' enterprises. [*Banco Espanol de Credito v. Security Pac. Nat'l Bank* (2nd Cir. 1992) 973 F2d 51, 55-56; also see *Resolution Trust Corp. v. Stone* (10th Cir. 1993) 998 F2d 1534, 1537-1540 (abrogation on other grounds recognized by *Johnson v. Heath* (10th Cir. 2022) 56 F4th 851, 860)—car loans purchased from automobile dealers and resold to financial institutions in packages containing credit enhancements ("enhanced automobile receivables" or EARs) are commercial transactions and not "securities"]

• [5:39.5d] By contrast, interests in fixed-rate, short-term bridge loans for construction and cooperative conversions were "securities" when the seller's motivation was to raise funds for general business purposes and the motivation of the buyers, who were passive and unsophisticated in this type of transaction, was investment. [*Pollack v. Laidlaw Holdings, Inc.* (2nd Cir. 1994) 27 F3d 808, 812-814]

• [5:39.5e] Similarly, notes were "securities" when used for general overhead expenses (not merely to correct temporary cash-flow difficulties) in the course of a reorganization of business operations caused by the owner's divorce-related financial problems. [*McNabb v. SEC* (9th Cir. 2002) 298 F3d 1126, 1129, 1132]

[5:39.5f] ***Reserved.***

b) [5:39.5g] **Manner of distribution:** If the note is issued as part of a *public distribution*, or otherwise is of a type that is commonly traded for speculation or investment, it is likely to be a "security." [*Reves v. Ernst & Young* (1990) 494 US 56, 66, 110 S.Ct. 945, 952]

The *number* of purchasers is not necessarily dispositive, but rather must be weighed against the purchasers' need for the protection of the securities laws. Notes sold to private individuals are more likely to be "securities" than notes sold to sophisticated financial institutions. [See *McNabb v. SEC* (9th Cir. 2002) 298 F3d 1126, 1132; *Stoiber v. SEC* (DC Cir. 1998) 161 F3d 745, 751]

c) [5:39.5h] **Investors' reasonable expectations:** If investors could reasonably believe they were making an investment—e.g., because the issuer advertised the notes as "investments"—the notes are "securities." [*Reves v. Ernst & Young* (1990) 494 US 56, 66, 110 S.Ct. 945, 952]

Here, the court must look to a *reasonable investor*, not the specific individuals in question. [*McNabb v. SEC* (9th Cir. 2002) 298 F3d 1126, 1132; *SEC v. J.T. Wallenbrock & Assocs.* (9th Cir. 2002) 313 F3d 532, 539]

d) [5:39.5i] **Existence of risk-reducing factors:** The note is *less likely* to be a "security" where it is *secured* or *insured*, or where a comprehensive *federal* regulatory scheme applies (such as ERISA or federal banking regulations) that *significantly reduces the instrument's risk*, rendering application of the federal securities laws unnecessary. [*Reves v. Ernst & Young* (1990) 494 US 56, 67-69, 110 S.Ct. 945, 952-953; see *SEC v. J.T. Wallenbrock & Assocs.* (9th Cir. 2002) 313 F3d 532, 540; also see *Resolution Trust Corp. v. Stone* (10th Cir. 1993) 998 F2d 1534, 1539 (abrogation on other grounds recognized by *Johnson v. Heath* (10th Cir. 2022) 56 F4th 851, 860)—vehicles collateralizing "enhanced automobile receivables" (EARS) tended to disprove existence of security]

1/ [5:39.6] **State regulation not adequate:** The fact that an issuer is subject to regulation by a single state is inadequate to remove the issuer from under the umbrella of the federal securities laws. Moreover, "a patch-work of state regulation, which applies to most business entities in some fashion or another, cannot displace the federal regime." [*SEC v. J.T. Wallenbrock & Assocs.* (9th Cir. 2002) 313 F3d 532, 540]

[5:39.6a - 5:39.6c] ***Reserved.***

(c) [5:39.6d] **Compare—private, negotiated agreements:** Of course, "ordinary, *individually* negotiated private commercial loan transactions" do not constitute investment contracts and, hence, are not "securities." Reason: These agreements are *unique* (i.e., negotiated one-on-one) and never intended to be publicly offered or traded. [*Mace Neufeld Productions, Inc. v. Orion Pictures Corp.* (9th Cir. 1988) 860 F2d 944, 947 (emphasis added)]

(d) Compare—California law

1) [5:39.7] **Short-term notes:** The California Securities Law exempts notes arising out of current transactions with a maturity not exceeding nine months, *provided* that the notes are not offered to the public in amounts of less than $25,000 in the aggregate to any one purchaser. [Corps.C. § 25100(*l*)]

2) [5:39.8] **Long-term notes:** The statutory definition of "security" literally includes any other (i.e., long-term) note, evidence of indebtedness, etc. [Corps.C. § 25019]

However, California courts have found that a long-term note constitutes a "security" *only if:*

- The investment is made with an expectation of profit other than just the payment of interest (and principal), or the investor is given an interest in the business. [*People v. Davenport* (1939) 13 C2d 681, 690, 91 P2d 892, 897]

- Or, the investment constitutes "risk capital," repayment of which is substantially unsecured and thus dependent upon success of the business, which is in turn dependent upon the efforts of others. [*People v. Figueroa* (1986) 41 C3d 714, 736, 224 CR 719, 735; *People v. Black* (2017) 8 CA5th 889, 902-909, 214 CR3d 402, 413-419; *People v. Butler* (2012) 212 CA4th 404, 414, 151 CR3d 352, 361; see *People v. Simon* (1995) 9 C4th 493, 497, 37 CR2d 278, 280, fn. 4]

3) [5:39.9] **Convertible notes:** Finally, notes that are convertible into another security (e.g., common stock), or that otherwise represent a right to obtain a security, themselves constitute securities. [Corps.C. § 25019]

(4) Partnership, joint venture and LLC

(a) [5:40] **General partnerships and joint ventures:** Here again, the test applied by the courts is whether the general partnership or joint venture interests constitute "investment contracts" (¶ *5:33*). Ordinarily, a general partnership or joint

venture interest is *not* a "security," because general partners and joint venturers normally have control rights and take an active part in management of the business. "General partners are, in short, entrepreneurs, not investors." [*SEC v. Arcturus Corp.* (5th Cir. 2019) 928 F3d 400, 410 (internal quotes omitted); see *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.* (4th Cir. 1988) 840 F2d 236, 240-241—"strong presumption" that general partnership interests are not securities; *Goodwin v. Elkins & Co.* (3rd Cir. 1984) 730 F2d 99, 102-103]

But the result may be otherwise if there are "other factors which implicate the investors' practical ability to control their investment." [*SEC v. Schooler* (9th Cir. 2018) 905 F3d 1107, 1110—"Dressing an investment contract in the trappings of a general partnership interest does not immunize that interest from the federal securities laws"; *Koch v. Hankins* (9th Cir. 1991) 928 F2d 1471, 1476; *Consolidated Mgmt. Group, LLC v. Department of Corporations* (2008) 162 CA4th 598, 609-614, 75 CR3d 795, 804-809—Commissioner validly issued "desist and refrain" order enjoining offering of joint venture interests determined to be "securities"; *SEC v. Shields* (10th Cir. 2014) 744 F3d 633, 642-645]

1) [5:40.1] **Three-prong approach:** Courts examine the economic reality of the interest. A general partnership or joint venture interest is a "security" if the court finds *any* of the following three factors (sometimes referred to as the "*Williamson* factors"). [*SEC v. Schooler* (9th Cir. 2018) 905 F3d 1107, 1112; *Consolidated Mgmt. Group, LLC v. Department of Corporations* (2008) 162 CA4th 598, 610-611, 614, 75 CR3d 795, 806, 809; *SEC v. Arcturus Corp.* (5th Cir. 2019) 928 F3d 400, 410-411; see *Williamson v. Tucker* (5th Cir. 1981) 645 F2d 404, 424]

a) [5:40.2] **Agreement does not confer control rights:** The interest will be a "security" if the partnership or joint venture agreement on its face leaves so little power in the hands of the investor that the arrangement in fact distributes power as would a limited partnership. [*SEC v. Schooler* (9th Cir. 2018) 905 F3d 1107, 1112-1114; *Koch v. Hankins* (9th Cir. 1991) 928 F2d 1471, 1476-1477; *Hocking v. Dubois* (9th Cir. 1989) 885 F2d 1449, 1460-1462 (en banc); *Consolidated Mgmt. Group, LLC v. Department of Corporations* (2008) 162 CA4th 598, 610-611, 75 CR3d 795, 805-806]

b) [5:40.3] **Investor incapable of exercising control rights:** Even though the agreement confers control rights on the investor, a "security" is still present if, as a practical matter, the investor is incapable of intelligently exercising those rights. But courts disagree as to what level the investor's business acumen should be assessed:

• [5:40.3a] A California court, following the Fifth Circuit, focused on the investor's experience and knowledge in the partnership's or venture's *particular area of business*. [*Consolidated Mgmt. Group, LLC v. Department of Corporations* (2008) 162 CA4th 598, 611-613, 75 CR3d 795, 806-808; see *Long v. Shultz Cattle Co., Inc.* (5th Cir. 1989) 881 F2d 129, 135; see also *SEC v. Arcturus Corp.* (5th Cir. 2019) 928 F3d 400, 417-422; *SEC v. Shields* (10th Cir. 2014) 744 F3d 633, 647]

• [5:40.3b] In contrast, the Ninth Circuit focuses on the investor's experience and knowledge in *business affairs generally* rather than in the business' particular industry or area. [*Holden v. Hagopian* (9th Cir. 1992) 978 F2d 1115, 1121-1123; *Koch v. Hankins* (9th Cir. 1991) 928 F2d 1471, 1479]

c) [5:40.4] **Business dependent on unique abilities of others:** Even though investors have control rights and the capacity to exercise them intelligently, a partnership or joint venture interest will nevertheless be a "security" if the investors, as a practical matter, are reliant upon unique and irreplaceable entrepreneurial or managerial abilities of the promoter or manager, or otherwise cannot exercise meaningful partnership or venture powers. [*Koch v. Hankins* (9th Cir. 1991) 928 F2d 1471, 1476-1477; *Hocking v. Dubois* (9th Cir. 1989) 885 F2d 1449, 1460-1462; *Consolidated Mgmt. Group, LLC v. Department of Corporations* (2008) 162 CA4th 598, 613-614, 75 CR3d 795, 808-809]

1/ [5:40.5] **Comment:** The investor must show that the reliance on the promoter that forms the basis of the investor's expectations arose out of the original transaction—i.e., at the time of the investment, *not* at some later time. [*Holden v. Hagopian* (9th Cir. 1992) 978 F2d 1115, 1119, fn. 6; *Koch v. Hankins* (9th Cir. 1991) 928 F2d 1471, 1476-1477; see *Consolidated Mgmt. Group, LLC v. Department of Corporations* (2008) 162 CA4th 598, 614, 75 CR3d 795, 808-809]

2) Application

• [5:40.6] A 2700-acre plantation was syndicated into 35 separate general partnerships, each with an 80-acre parcel, for the cultivation of jojoba beans. The powers granted the partners under each partnership agreement could be

exercised only within the respective parcel. However, the plantation was managed and operated as a whole. To the extent no individual parcel was economically viable on its own and the individual partners had no ability to control the whole plantation, the partners would have to rely on the plantation managers to achieve their original profit expectations. Thus, the general partners could be found to have purchased an "investment contract." [*Koch v. Hankins* (9th Cir. 1991) 928 F2d 1471, 1476-1477]

• [5:40.7] Interests in joint ventures that purchased and leased out oil and gas exploration and drilling equipment were "investment contracts." The venture agreements designated a limited liability company affiliated with the promoters as the managing venturer with authority over day-to-day operations. Although the agreements gave all venturers collective management and control and the right to remove the manager by majority vote, the investors had no oil and gas experience and thus could not effectively exercise managerial powers (*see ¶ 5:40.3a*). Moreover, the venture depended on the manager's unique expertise in selecting and purchasing equipment from affiliates of the manager and then leasing out the equipment for use at existing wells in which the manager had rights. [*Consolidated Mgmt. Group, LLC v. Department of Corporations* (2008) 162 CA4th 598, 609-614, 75 CR3d 795, 804-809; see *SEC v. Arcturus Corp.* (5th Cir. 2019) 928 F3d 400, 404-424—triable factual issue whether joint venture interests in oil and gas drilling projects were "investment contracts"]

• [5:40.8] A promoter purchased tracts of undeveloped land in the name of his wholly-owned corporation and then substantially marked up their price to sell to investors through general partnership interests. Each partnership agreement stated that it became effective upon a date that was intentionally left blank. Until the effective date was inserted, the investors had no power to control their investments. During this period, the promoter expended 93% of the investors' money and made all meaningful investment decisions, including which parcels to purchase and their price. Further, the large number of partners made it "potentially unworkable" for them to manage the parcels, and the promoter and his associates exercised all practical management authority. The facts indisputably showed that the general partnership interests were in fact passive investment contracts. [*SEC v. Schooler* (9th Cir. 2018) 905 F3d 1107, 1113]

• [5:40.9] *Compare:* Working interests in oil and gas wells sold to knowledgeable and sophisticated investors were *not* "investment contracts" where the investors retained managerial powers that they were fully capable of exercising. [*Stewart v. Ragland* (9th Cir. 1991) 934 F2d 1033, 1037-1040]

(b) [5:41] **Limited partnerships:** Limited partnership interests are usually held to be "securities" under both federal and California law since, by nature, limited partners are supposed to be passive investors; i.e., their expectation of profits is based *primarily* on the efforts of others (the general partners). [See *People v. Simon* (1995) 9 C4th 493, 499, 37 CR2d 278, 281; *SEC v. Feng* (9th Cir. 2019) 935 F3d 721, 729; *SEC v. Arcturus Corp.* (5th Cir. 2019) 928 F3d 400, 410; compare *Steinhardt Group Inc. v. Citicorp* (3rd Cir. 1997) 126 F3d 144, 152-155—limited partners not passive investors where partnership agreement gave them extensive control over partnership business]

(c) [5:41.1] **LLC memberships:** Here again, the test under *federal* law is whether membership interests in a limited liability company are "investment contracts" (*¶ 5:33 ff.*).

Under *California* law, however, LLC membership interests are securities *unless all* of the members are *actively engaged in management.* The burden of proof is on the person claiming the exception; merely showing that all members vote (or have the right to vote), or have the right to information about the LLC's business and affairs, or otherwise have the right to participate in management, will *not*, without more, establish that all members are in fact actively engaged in management. [Corps.C. § 25019]

[5:41.2 - 5:41.5] ***Reserved.***

(5) [5:41.6] **Offerings of "cybercurrency" and other "digital assets":** In recent years some "cyber" or "virtual" companies have raised cash not by selling stock or other ownership interests but, rather, by selling "digital assets" such as "cybercurrency," "virtual currency," "digital currency," "digital tokens," "cryptocurrency," etc. First-time offerings are sometimes referred to as "initial coin offerings" or "ICOs."

This is an emerging area that is in constant flux. The SEC has taken the position that offerings of digital assets may constitute "investment contracts" (*see ¶ 5:33 ff.*) and hence may involve an offering of "securities" that cannot be sold absent 1933 Act registration or an appropriate exemption from registration. [See SEC Division of

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Corporation Finance, Framework for "Investment Contract" Analysis of Digital Assets (4/3/19), available on the SEC's website at *www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets*; see also Spotlight on Initial Coin Offerings (ICOs), available on the SEC's website at *www.sec.gov/ICO*]

(6) [5:42] **Exempt securities:** Certain securities are exempt from the registration requirements of the 1933 Act: e.g., securities issued or guaranteed by federal, state or local governments; or by religious, educational, charitable and other nonprofit institutions; or by bank, savings and loan associations, and other issuers subject to specific governmental control and regulation. [SA § 3(a)(2) (15 USC § 77c(a)(2)); see also SEA § 3(a)(12) (15 USC § 78c(a)(12))]

(a) [5:43] **Preemption of state law; California exemptions:** The California Corporate Securities Law contains similar exemptions. [See Corps.C. § 25100; *¶ 5:195.5*]

Additionally, the 1933 Act expressly preempts state laws that would otherwise require qualification of many of these securities. [SA § 18(a), (b)(4)(E) (15 USC § 77r(a), (b)(4)(E)); *see ¶ 5:18.5 ff.*]

(b) [5:44] **Caution—antifraud rules still apply:** Even if the security is exempt from registration requirements under the 1933 Act, the anti-fraud and civil liability provisions of SEC Rule 10b-5 still apply; *see¶ 6:360 ff.*

3. [5:45] **Registration Procedure:** As previously stated (¶ 5:19), the 1933 Act prohibits the sale of any security subject to the Act unless a registration statement has been filed with the SEC and has "become effective." [SA § 5(a) (15 USC § 77e(a))]

a. [5:46] **Registration statement:** The issuer is required to provide, on forms prescribed by the SEC, a detailed statement of all material facts relating to the proposed investment. Basically, the issuer must furnish all information needed by the average investor in order to evaluate the securities being offered, and to make an informed investment decision thereon. [See *California Pub. Employees' Retirement System v. ANZ Secur., Inc.* (2017) 582 US 497, 501, 137 S.Ct. 2042, 2047; *Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund* (2015) 575 US 175, 178-179, 135 S.Ct. 1318, 1323]

(1) [5:47] **Contents:** In general, the forms require detailed information as to:

• The issuer's business;

• The identity and background of all corporate officers and directors;

• The compensation they receive;

• The nature of the security being offered and of any other securities outstanding;

• Sales and underwriting costs and commissions;

• Planned utilization of the proceeds from the issuance; and

• The risk factors involved in the investment. [See SA § 7 (15 USC § 77g)]

(2) [5:48] **Key disclosures in prospectus:** The registration statement actually consists of two parts: a statutory prospectus that sets forth the key information contained in the registration statement, and a copy of which must be furnished to every purchaser at or prior to their purchase; and "*Part II*," containing information and exhibits that need not be furnished to every purchaser, but that must be available for public inspection in the SEC's files and on the Electronic Data Gathering, Analysis and Retrieval (EDGAR) portion of the SEC's website (*www.sec.gov*). [SA § 10 (15 USC § 77j)]

(a) [5:48.1] **"Plain English" requirement:** The statutory prospectus *should*—and indeed, certain portions (the cover page, summary and risk factors) *must*—be written in "plain English." Among other things, the "plain English" rules require short sentences, definite, "everyday" language and the active (not passive) voice, and ban legal jargon, highly technical business terms and multiple negatives. [See SEC Rules 421(d), 461(b)(1) (17 CFR §§ 230.421(d), 230.461(b)(1)); Reg. S-K, Items 501-503 (17 CFR Part 229)]

➪ [5:48.2] ***PRACTICE POINTER:*** Tips and techniques for writing in plain English are contained in *A Plain English Handbook: How to Create Clear SEC Disclosure Documents* (3/30/99), available at the SEC's website (*www.sec.gov*).

(3) [5:49] **Registration statement forms:** The SEC provides several different forms for registration statements, depending on the type of issuer or transaction. Some of the more widely used forms are:

• Form S-1, the basic form prescribed for use by all issuers unless another form is authorized. (But reduced information is required for "emerging growth companies"—generally, corporations with annual revenues of less than $1.07 billion; and even less information is required for "smaller reporting companies"—generally, corporations with less than $250 million of "public float" or, if no "public float" or a "public float" of less than $700 million, less than $100 million in annual revenues.)

• Form S-3, used by issuers registered under the 1934 Act who have been filing reports as required thereunder for at least 12 months and who meet other conditions. (Form S-3 permits a large part of the information required for registration to be incorporated by reference to such reports.)

• Form S-4, used for mergers and other business combinations.

• Form S-8, used for employee stock purchase plans.

• Form S-11, used by certain real estate companies (e.g., REITs).

[5:50 - 5:53] ***Reserved.***

b. [5:54] **Filing and effective date:** As stated above (¶ 5:45), no offer to sell may be made by the issuer until the registration statement is *filed;* and no sale may take place until the statement has "*become effective*."

(1) [5:54.1] **Exception for preregistration communications to certain institutional investors or by "Well-Known Seasoned Issuers":** Before filing a registration statement, an issuer (or someone authorized to act on the issuer's behalf) may nonetheless engage in oral or written communications with potential investors whom the issuer reasonably believes to be either *qualified institutional buyers* (per SEC Rule 144A, ¶ 5:130 ff.) or *institutions* that are *accredited investors* (*see ¶ 5:174 ff.*) in order to determine whether such investors might have an interest in the contemplated registered offering. [SEC Rule 163B (17 CFR § 230.163B)]

Also, under certain conditions, "Well-Known Seasoned Issuers" (large, seasoned issuers with outstanding equity securities having a market value of $700 million or more held by nonaffiliates) may make oral and written communications about a securities offering before filing a registration statement. [SEC Rules 163, 405 (17 CFR §§ 230.163, 230.405)]

(2) [5:55] **Waiting period:** The period between the date the registration is filed and the date it "becomes effective" is known as the "waiting period." During this period, the issuer may make *oral* offers to sell its shares, and may accompany this with a preliminary prospectus—i.e., a copy of the prospectus filed with the registration statement (known as a "red herring"). But no *written* offer or agreement to sell the securities may be entered into at this point. [SA § 5(b)(1) (15 USC § 77e(b)(1))]

(3) [5:56] **Effective date:** A registration statement "becomes effective" *20 days* after it is filed *unless* the SEC issues a stop order delaying its effectiveness. [SA § 8(b) (15 USC § 77h(b))]

Commonly, no formal stop-order is issued. But, before expiration of the 20-day period, the SEC will require *amendments* to the registration statement (usually to amplify or supply additional information). When filed, each such amendment starts the 20-day period anew, unless the SEC grants an accelerated effective date. [SA § 9(a) (15 USC § 77i(a))]

(a) [5:56.1] **Delaying amendment:** To control the timing of the effective date once SEC clearance has been obtained, it is common practice for issuers to file a "delaying amendment" with the SEC specifying the desired effective date.

[5:56.2 - 5:56.4] ***Reserved.***

(4) [5:56.5] **Effective only for offering properly covered thereby:** An "effective" registration statement permits the issuer to make only those *offers and sales* properly covered thereby. [See *SEC v. Phan* (9th Cir. 2007) 500 F3d 895, 901-905—securities registered under Form S-8 (employee/consultant stock purchase plans; *see ¶ 5:49*) for issuance to consultant did not cover consultant's resales where issuance was subterfuge for public offering]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Indeed, it is something of a misnomer to speak of "registered securities": It is the specific *offering* that is "registered"—*not the securities* themselves. [*SEC v. Cavanagh* (2nd Cir. 1998) 155 F3d 129, 133—registration statement covering issuance to management did not cover reoffering of shares to other persons]

(5) [5:56.6] **Subsequent periodic reports required:** An issuer that files a registration statement becomes subject to the reporting requirements of SEA § 13 (quarterly, annual and other reports) for the issuer's fiscal year in which the registration statement became effective. [SEA § 15(d)(1) (15 USC § 78***o***(d)(1))]

4. [5:57] **Enforcement Provisions:** The 1933 Act provides both civil and criminal sanctions for violation of its registration requirements, or for any "fraud" in connection with filing of the registration statement or issuance of the securities.

a. [5:57.1] **Extraterritorial application:** Federal district courts have jurisdiction over proceedings brought by the *United States* or *SEC* (*not private persons*) alleging a violation of SA § 17(a) (fraudulent activity in connection with securities sales; 15 USC § 77q(a); *see* *¶ 5:74*) arising from:

"(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or

"(2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States." [SA § 22(c) (15 USC § 77v(c)); see SEA § 27(b) (15 USC § 78aa(b))—similar grant of jurisdiction to federal district courts for actions by U.S. or SEC alleging violation of 1934 Act antifraud provisions arising from extraterritorial conduct]

It is not entirely clear whether SE § 22(c) (and SEA § 27(b)) extend the *antifraud* provisions of the federal securities laws to extraterritorial conduct:

• The U.S. Supreme Court, in a case decided while Congress contemplated the amendments that resulted in the present versions of SA § 22(c) and SEA § 27(b), held that the antifraud provisions apply to fraudulent conduct *outside the U.S. directed at American securities markets and investors*, but *not* to fraudulent conduct *occurring in the U.S.* in connection with securities offerings or sales *to foreign nationals outside the U.S.* [*Morrison v. National Australia Bank Ltd.* (2010) 561 US 247, 254-273, 130 S.Ct. 2869, 2877-2888 (effectively overruling circuit court holdings that extended securities laws' application to fraudulent conduct within U.S. in connection with offshore securities transactions); see *Stoyas v. Toshiba Corp.* (9th Cir. 2018) 896 F3d 933, 945-947 (SEA case), *discussed at* *¶ 6:362.2*]

• However, the Tenth Circuit held that SE § 22(c) and SEA § 27(b) effectively supersede *Morrison*, supra, and hence that the substantive antifraud provisions apply when the requirements of SE § 22(c) and SEA § 27(b) are otherwise met. [*SEC v. Scoville* (10th Cir. 2019) 913 F3d 1204, 1215-1218; compare *SEC v. Chicago Convention Ctr., LLC* (ND IL 2013) 961 F.Supp.2d 905, 909-917—unclear whether SA § 22(c) and SEA § 27(b) superseded *Morrison*, supra]

In any event, the 1933 Act's *registration* requirements do *not* apply to securities offerings and sales made by foreign *or U.S.* issuers to foreign nationals outside the U.S. so long as the issuer observes somewhat complex "safe harbor" provisions designed primarily to ensure that sales efforts are directed abroad and the securities are not resold to U.S. investors within designated time periods following the sale. [SEC Reg. S, Rules 901-905 (17 CFR § 230.901 et seq.)]

b. [5:58] **Civil liability for misstatements or omissions in registration statement (SA § 11):** The 1933 Act imposes liability on designated persons for *misstatements or omissions* of *material facts* in a registration statement or offering prospectus. [SA § 11 (15 USC § 77k); see *California Pub. Employees' Retirement System v. ANZ Secur., Inc.* (2017) 582 US 497, 501-502, 137 S.Ct. 2042, 2047; *Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund* (2015) 575 US 175, 179, 135 S.Ct. 1318, 1323]

(1) [5:58a] **Determined at time registration statement became effective:** The misrepresentation or omission must have existed at the time the registration statement became effective. Thus, misrepresentations by corporate officers or directors (or other persons) made after the registration statement became effective are not actionable under § 11. Similarly, posteffective-date events that were not and could not have been known at the time the registration statement became effective cannot form the basis of an actionable "omission" in the registration statement. [See *Rubke v. Capitol Bancorp Ltd.* (9th Cir. 2009) 551 F3d 1156, 1164; *Cooperman v. Individual, Inc.* (1st Cir. 1999) 171 F3d 43, 47-49]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [5:58.1] **"Materiality" limitation:** Only misrepresentations of "*material*" fact are actionable under § 11. The test for "materiality" is the same under § 11, § 12(a)(2) (*¶ 5:65 ff.*), SEC Rule 10b-5 (*see¶ 6:369*), and the federal proxy rules (*see¶ 6:108*)—i.e., "whether the existence or nonexistence of the fact in question is a matter to which a reasonable [person] would attach importance in determining his [or her] choice of action in the transaction." [*SEC v. Seaboard Corp.* (9th Cir. 1982) 677 F2d 1301, 1306; *Miller v. Thane Int'l, Inc.* (9th Cir. 2008) 519 F3d 879, 888—issuer's misrepresentations that stock would be listed on Nasdaq were material as matter of law (decided under SA § 12(a)(2), *¶ 5:65 ff.*); *In re Worlds of Wonder Secur. Litig.* (9th Cir. 1994) 35 F3d 1407, 1423-1424]

[5:58.1a - 5:58.1c] ***Reserved.***

(a) [5:58.1d] **SEC-mandated disclosures presumed material:** The issuer's failure to disclose information required by SEC rule or regulation (particularly Reg. S–K, which sets forth information required to be disclosed in a registration statement) is an actionable omission. "[D]isclosures mandated by law are presumably material." [*Steckman v. Hart Brewing, Inc.* (9th Cir. 1998) 143 F3d 1293, 1296 (but finding no liability on facts), quoting *Craftmatic Secur. Litig. v. Kraftsow* (3rd Cir. 1990) 890 F2d 628, 641, fn. 17; see *Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund* (2015) 575 US 175, 186, 135 S.Ct. 1318, 1327, fn. 3 (dictum)]

(b) [5:58.1e] **Financial "materiality" not solely quantitative:** In determining whether a financial item is material, issuers and their auditors should not rely exclusively on quantitative benchmarks (e.g., overstatement of income not material if less than 5%). Materiality is not solely a "numbers game." The standard is whether, in light of all the surrounding circumstances, a *reasonable investor* would consider the item important; and reasonable investors do not necessarily base their evaluations on quantitative benchmarks. [SEC Staff Accounting Bulletin No. 99 (1999)]

(c) [5:58.2] **Statements of opinion:** A statement of opinion that proves untrue can be actionable as a misrepresentation of *fact* if the person rendering the opinion *actually knew* the statement was not true or *did not sincerely believe* the statement to be true. [*Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund* (2015) 575 US 175, 182-186, 135 S.Ct. 1318, 1325-1327 & fn. 2; see *Macomb County Employees' Retirement System v. Align Tech., Inc.* (9th Cir. 2022) 39 F4th 1092, 1099—senior executives' "vague, generically positive terms" describing corporation's performance in China constituted nonactionable "puffery"]

1) [5:58.2a] **Omission of fact; misleading statement:** Even when sincerely believed true, an opinion may be actionable if the issuer omits a material fact that renders the issuer's published statement misleading to a reasonable investor—i.e., the excluded fact shows that the issuer lacked the factual basis for stating the opinion that a reasonable investor would expect. [*Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund* (2015) 575 US 175, 194-196, 135 S.Ct. 1318, 1332-1333]

What a reasonable investor would expect is determined *objectively* based on the entire context of the registration statement. [*Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund*, supra, 575 US at 184-195, 135 S.Ct. at 1326-1332—investors do not expect opinions in registration statements "to reflect baseless, off-the-cuff judgments, of the kind that an individual might communicate in daily life"; see *Tongue v. Sanofi* (2nd Cir. 2016) 816 F3d 199, 209-214—issuer not liable for incorrect opinion where issuer merely failed to disclose a fact that would undermine the opinion; *City of Warren Police & Fire System v. Natera Inc.* (2020) 46 CA5th 946, 955-957, 259 CR3d 890, 897-899—statements that company was "rapidly growing" and its "rapid growth of revenues" was based on product's success were not false or misleading because company's statement disclosed declining revenues and increasing costs, contained warnings cautioning against reliance on historical results, and warned that product sales could decrease]

2) [5:58.3] **Forecasts:** Similarly, liability may lie for unfounded forecasts and projections that prove material and false. However, an issuer is not liable for "forward-looking statements" that are accompanied by "meaningful cautionary statements." To be meaningful, the cautionary language must "identify[] important factors that could cause actual results to differ materially from those in the forward-looking statement." [SA § 27A (15 USC § 77z-2); see also SEA § 28(e) (15 USC § 78u-5); *and ¶ 6:370c ff.*]

Cautionary language is not "meaningful" if it omits a specific risk of which an issuer is aware. [*Glazer Capital Mgmt., L.P. v. Forescout Techs., Inc.* (9th Cir. 2023) 63 F4th 747, 780-781—statement that corporation expected merger with another company to close not protected where it failed to disclose known risk that other company was

considering backing out; compare *In re Worlds of Wonder Secur. Litig.* (9th Cir. 1994) 35 F3d 1407, 1413-1415—forecasts regarding corporation's future performance in prospectus for junk bond offering not materially misleading as matter of law since they contained sufficient cautions and disclaimers regarding risks]

3) [5:58.4] **Proxy statements:** *Omnicare's* standards (¶ 5:58.2 ff.) also apply to statements of opinion in proxy statements. [*Golub v. Gigamon* (9th Cir. 2021) 994 F3d 1102, 1107]

(3) [5:59] **Who may sue; tracing requirement:** Either the original purchasers of the securities *or any subsequent purchasers or transferees* may sue, so long as their securities were issued under the defective registration statement—i.e., so long as they can *trace* their securities to the registration statement in question and not some other registration statement. In general, plaintiff need *not* prove reliance on the particular misstatement or omission in order to recover under the 1933 Act. (However, plaintiff must have purchased without knowledge of the falsity.) [See *In re Century Aluminum Co. Secur. Litig.* (9th Cir. 2013) 729 F3d 1104, 1106; *Hildes v. Arthur Andersen LLP* (9th Cir. 2013) 734 F3d 854, 859-860; *Amtower v. Photon Dynamics, Inc.* (2008) 158 CA4th 1582, 1596, 71 CR3d 361, 374]

(a) [5:59.1] **Comment—impact of tracing requirement:** The tracing requirement can effectively eliminate an SA § 11 remedy.

1) [5:59.2] **Example:** A public company with more than 49 million outstanding shares issued an additional 24.5 million shares in an underwritten offering pursuant to a defective registration statement. A plaintiff who purchased 5,000 shares on the open market at $4.56 per share (rather than directly from the underwriter at the $4.50 offering price) had to show those shares were part of the 24.5 million new issue. In an active market with many purchasers and sellers (including sellers whose shares were acquired prior to, but sold after, the new issue), it may be impossible to trace plaintiff's shares to the registration statement. This is so even where plaintiff's shares were purchased on the *same day* as the offering. [See *In re Century Aluminum Co. Secur. Litig.* (9th Cir. 2013) 729 F3d 1104, 1106-1107; also see *In re Ariad Pharmaceuticals, Inc. Secur. Litig.* (1st Cir. 2016) 842 F3d 744, 755-756; *Krim v. pcOrder.com, Inc.* (5th Cir. 2005) 402 F3d 489, 496-497—"very high mathematical probability" that plaintiff's stock traceable to registration statement not sufficient]

(b) [5:59.3] **Applies to secondary market purchasers:** Purchasers of investment company securities, such as exchange-traded funds (ETFs), are also subject to the tracing requirement, even if it may be impossible to satisfy. [*Jensen v. iShares Trust* (2020) 44 CA5th 618, 635-639, 258 CR3d 1, 14-17—Investment Company Act of 1940, 15 USC § 80a et seq., did not eliminate SA § 11's standing requirements]

[5:59.4] ***Reserved.***

(c) [5:59.5] **Surviving corporation in merger has no § 11 claim:** Upon merger, a disappearing corporation *and its stock* cease to exist. Despite surrender and cancellation of the disappearing corporation's shares, the surviving corporation is not "acquiring [a] … security," and thus may not sue under § 11 for a false premerger registration statement filed by the disappearing corporation. [*Versyss Inc. v. Coopers & Lybrand* (1st Cir. 1992) 982 F2d 653, 655-656—surviving corporation acquired assets and liabilities of disappearing corporation, not its stock; see *In re Broderbund/Learning Co. Secur. Litig.* (9th Cir. 2002) 294 F3d 1201, 1204]

(*Compare:* Exchange of stock in a merger *does* constitute a purchase and sale of securities by the *disappearing corporation's shareholders*. See *In re Broderbund/Learning Co. Secur. Litig.*, supra; *SEC v. National Secur., Inc.* (1969) 393 US 453, 466, 89 S.Ct. 564, 571 (decided under SEA § 10(b) and SEC Rule 10b-5).)

(d) [5:59.6] **Unregistered shares in direct listing:** A shareholder who purchased unregistered shares offered in a direct listing has standing under SA § 11. In a direct listing, the issuer sells registered securities and existing stockholders may sell their unregistered securities directly to the public. In this situation, liability under SA § 11 extends *only* to shares that are *traceable* to the allegedly defective registration statement. [*Slack Techs., LLC v. Pirani* (2023) 598 US 759, 768, 143 S.Ct. 1433, 1440-1441]

(4) [5:60] **Who may be held liable:** The persons who may be held liable include:

- All persons who actually *signed* the statement (the corporation, its chief executive and accounting officers, and a majority of its board of directors; see SA § 6(a) (15 USC § 77f(a))).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• All *directors* of the issuer, even if they did not sign.

• Every person named therein, with their consent, as "about to become" a director.

• Every *expert* who certified or "expertised" any portion of the statement (e.g., accountant certifying financial statements, lawyer rendering tax opinion).

• Every *underwriter* involved in distribution of the securities.

• Any person who is in "*control*" of the corporation (through stock ownership or other actual power to control) unless they had no reason to know of the misstatements or omissions. [See SA §§ 11, 15 (15 USC §§ 77k, 77***o***); see also *Hellum v. Breyer* (2011) 194 CA4th 1300, 1314-1317, 123 CR3d 803, 813-816—complaint survives demurrer if it adequately pleads defendant had direct or indirect *power* to control corporation (complaint need not plead defendant actually *exercised* control)]

(a) [5:60.1] **Scienter not required:** Defendants may be liable even for *innocent* or *negligent* misstatements or omissions. [*Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund* (2015) 575 US 175, 179, 190-193, 135 S.Ct. 1318, 1323, 1330-1331 & fns. 9, 11; *Herman & MacLean v. Huddleston* (1983) 459 US 375, 382, 103 S.Ct. 683, 687; *Hildes v. Arthur Andersen LLP* (9th Cir. 2013) 734 F3d 854, 859-860]

For this reason, SA § 11 has been described as a "strict liability statute." [*Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund*, supra, 575 US at 179, 193, 135 S.Ct. at 1323, 1331; *Amtower v. Photon Dynamics, Inc.* (2008) 158 CA4th 1582, 1596, 71 CR3d 361, 374]

(b) [5:61] **"Due diligence" defense:** All persons (other than the issuer) may defend on the ground that they *reasonably* believed the registration statement to be true and complete. Generally, this will require proof that they had no actual knowledge of falsity *and* that they made a *reasonable investigation* of the facts—i.e., what a prudent person would do in the management of their own affairs. [See *Escott v. BarChris Const. Corp.* (SD NY 1968) 283 F.Supp. 643, 683; also see *Monroe v. Hughes* (9th Cir. 1994) 31 F3d 772, 774-776—due diligence performed by accountants adequate as matter of law; *In re Software Toolworks Inc. Secur. Litig.* (9th Cir. 1994) 50 F3d 615, 626—due diligence performed by underwriters adequate as matter of law only in some respects]

(5) [5:62] **Scope of liability:** Plaintiffs are entitled to recover their actual loss in the investment. If the shares purchased were sold at a loss before suit is filed, they are entitled to recover such loss. If not sold, they are entitled to the decline in value between the price paid (normally the offering price) and the value at the time suit was filed. (Where shares are sold *after* filing suit, the sale price is used if this will *decrease* the damages.) [SA § 11(e) (15 USC § 77k(e)); see *In re Broderbund/Learning Co. Secur. Litig.* (9th Cir. 2002) 294 F3d 1201, 1204—no liability where stock received in merger exceeded value of surrendered stock notwithstanding postmerger decline in value]

(a) [5:62a] **No "benefit-of-the-bargain" damages:** SA § 11(e) sets forth the *exclusive measure* of damages for a SA § 11 claim. Specifically, disappointed investors may *not* recover damages for promised value or expected profit. [*McMahan & Co. v. Wherehouse Entertainment, Inc.* (2nd Cir. 1995) 65 F3d 1044, 1047-1048]

(b) [5:62b] **"Loss causation" defense as limitation on liability:** Notwithstanding a defendant's misrepresentation or omission, they are *not* liable for any portion of the loss or decrease in the stock's value that did *not result* from the deficient disclosure *attributable to that defendant*. Stated more simply, a defendant is liable only for damages caused by *that defendant's* misrepresentations or omissions. [SA § 11(e) (15 USC § 77k(e)); *In re Worlds of Wonder Secur. Litig.* (9th Cir. 1994) 35 F3d 1407, 1421-1423]

However, this "loss causation" defense is not as broad as it may appear … because the *defendant bears the burden of proof*, which, as a practical matter, is quite heavy. [SA § 11(e) (15 USC § 77k(e)); see *Hildes v. Arthur Andersen LLP* (9th Cir. 2013) 734 F3d 854, 859-861; *In re Worlds of Wonder Secur. Litig.*, supra, 35 F3d at 1421-1423; *Alaska Electrical Pension Fund v. Flowserve Corp.* (5th Cir. 2009) 572 F3d 221, 234]

[5:62c - 5:62d] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [5:62e] **Apportionment of liability:** Except for outside directors (¶ 5:62.1a), all SA § 11 defendants are *jointly and severally* liable. [SA § 11(f)(1) (15 USC § 77k(f)(1))]

1) [5:62.1] **Contribution and indemnification among defendants:** Although there is no *express or implied indemnification* right under SA § 11, anyone liable to make payment under that section has a right of *contribution* as against "any person who, if sued separately, would have been liable to make the same payment" (except in cases of fraudulent misrepresentation). [SA § 11(f)(1) (15 USC § 77k(f)(1)); see also *Laventhol, Krekstein, Horwath & Horwath v. Horwitch* (9th Cir. 1980) 637 F2d 672, 674-676; *and*¶ *5:71.4 ff.*]

2) [5:62.1a] **Outside director's liability:** An outside director is jointly and severally liable with other § 11 defendants only if the director engaged in a *knowing violation.* Outside directors who did not engage in knowing violations are responsible only to the extent they caused or contributed to plaintiff's loss; their *percentage of responsibility* is determined by the trier of fact. [SA § 11(f)(2) (15 USC § 77k(f)(2)); SEA § 21D(f)(2), (3) (15 USC § 78u-4(f)(2), (f)(3))]

a) [5:62.1b] **Exception for uncollectible judgments:** In addition to their proportionate share of responsibility for an unintentional ("unknowing") violation (¶ 5:62.1a), outside directors may be jointly and severally liable, *up to 50% of their share* of liability, for any portion of a judgment against a codefendant that proves uncollectible. [SEA § 21D(f)(4)(A)(ii) (15 USC § 78u-4(f)(4)(A)(ii))]

However, the 50% limitation does *not* apply if:

• Plaintiff's damages exceed 10% of their net worth, and

• The net worth is less than $200,000. [SEA § 21D(f)(4)(A)(i) (15 USC § 78u-4(f)(4)(A)(i))]

(d) Attorney fees and costs

1) [5:62.2] **Meritless claims:** Under SA § 11, the prevailing party is entitled to recover attorney fees and costs only if the unsuccessful suit or defense was "*without merit*." [SA § 11(e) (15 USC § 77k(e)) (emphasis added); *Layman v. Combs* (9th Cir. 1992) 994 F2d 1344, 1353—"without merit" standard encompasses claims and defenses that "border on the frivolous"; *Western Fed. Corp. v. Erickson* (9th Cir. 1984) 739 F2d 1439, 1444; *Amtower v. Photon Dynamics, Inc.* (2008) 158 CA4th 1582, 1601, 71 CR3d 361, 378-379—defendant awarded attorney fees where § 11 action was clearly barred by 1-year limitations period (¶ 5:63); compare *Friedman v. Ganassi* (3rd Cir. 1988) 853 F2d 207, 211—prevailing party may be awarded certain court costs under FRCP 54(d) regardless of merits of losing party's claim]

a) [5:62.2a] **No attorney liability:** SA § 11 attorney fees and costs are awardable only against the losing *parties*, *not* their attorneys. [*Healey v. Chelsea Resources, Ltd.* (2nd Cir. 1991) 947 F2d 611, 624-625]

b) [5:62.3] **Fee-shifting among multiple claims:** Where a suit contains multiple claims, only some of which provide for shifting of attorney fees to the prevailing party, an allocation must be made: The prevailing party is entitled to recover the amount in fees it would have incurred had the "shifting claims" been litigated *by themselves*. [See *Schultz v. Hembree* (9th Cir. 1992) 975 F2d 572, 577—allocation required in securities fraud case between fee-shifting state claims and other claims]

2) [5:62.4] **Mandatory FRCP 11 sanctions:** Upon final adjudication of any private action under the 1933 Act, the court must make specific findings regarding compliance by the parties *and their counsel* with each requirement of FRCP 11(b) as to any *complaint, responsive pleading* or *dispositive motion*. (Under FRCP 11(b), a paper submitted to the court by any attorney (or unrepresented party) is deemed to contain a certification that the claims, defenses, and/or other legal contentions are legally and factually supportable.) [SA § 27(c)(1) (15 USC § 77z-1(c)(1))]

If the court determines that a party or attorney violated FRCP 11(b), the court *must* (upon notice and opportunity to respond) award sanctions, unless the party or attorney being sanctioned proves the sanctions would be *unjust* and an *unreasonable burden*. [SA § 27(c)(2), (3) (15 USC § 77z-1(c)(2), (c)(3))]

a) [5:62.5] **Attorney fees and costs as presumptively proper sanction:** For failure of any *responsive pleading or dispositive motion* to comply with FRCP 11(b), an award of attorney fees and expenses incurred *as a direct result of the violation* is presumed appropriate. [SA § 27(c)(3)(A)(i) (15 USC § 77z-1(c)(3)(A)(i))]

For "substantial failure" of any *complaint* to comply with FRCP 11(b), an award of attorney fees and expenses incurred *in the action* is presumed appropriate. [SA § 27(c)(3)(A)(ii) (15 USC § 77z-1(c)(3)(A)(ii))]

Cross-refer: For a comprehensive treatment of FRCP 11 sanctions, see Stevenson & Fitzgerald, *Rutter Group Prac. Guide: Federal Civ. Pro. Before Trial* (TRG), Ch. 17.

(6) [5:63] **One-year/three-year statute of limitations:** Any action to enforce liability under SA § 11 must be commenced within *one year* after plaintiff *discovered*, or through the "exercise of reasonable diligence" *should have discovered*, the material misstatement or omission in the registration statement, and in any event *no later than three years* after the security was offered for public sale. [SA § 13 (15 USC § 77m); see *Amtower v. Photon Dynamics, Inc*. (2008) 158 CA4th 1582, 1596-1597, 71 CR3d 361, 374-375—action time-barred when filed more than one year after plaintiff received and read documents showing registration statement contained material omission]

(a) [5:63a] **Three-year period not tolled:** The three-year period is a statute of *repose* designed to provide defendants "full and final security" against future liability after three years. It contains no tolling provision, nor is it subject to the courts' judicial power to toll a limitations period for equitable reasons (so-called "equitable tolling"). [*California Pub. Employees' Retirement System v. ANZ Secur., Inc.* (2017) 582 US 497, 501-502, 137 S.Ct. 2042, 2049-2052—class action plaintiff who opted out of class could not bring separate action after 3-year period notwithstanding similarity between class and separate claims]

(b) [5:63b] **One-year period commenced by "inquiry notice"?** *See ¶ 5:72.5*.

(7) [5:63.1] **Heightened pleading standards where complaint sounds in fraud:** Where the SA § 11 claim "sounds in fraud," plaintiff must set forth the claim with "increased particularity" (per FRCP 9(b)). "To ascertain whether a complaint sounds in fraud, we must normally determine, after a close examination of the language and structure of the complaint, whether the complaint alleges a unified course of fraudulent conduct and relies entirely on that course of conduct as the basis of a claim." [*Rubke v. Capitol Bancorp Ltd.* (9th Cir. 2009) 551 F3d 1156, 1161 (internal quotes and brackets omitted) (but noting court can *assume* § 11 claim sounds in fraud where § 11 and SEC Rule 10b-5 claims (see ¶ 5:64) employ identical factual allegations); *In re Rigel Pharmaceuticals, Inc. Secur. Litig.* (9th Cir. 2012) 697 F3d 869, 885-886]

(a) [5:63.2] **Complaints based on statements of opinion:** A claim based on an actionable opinion (*see ¶ 5:58.2*) must do more than allege that the opinion was wrong. The complaint must "call into question the issuer's basis for offering the opinion." To do this, the complaint must identify *particular material facts* going to the *basis* for the opinion—facts about the *underlying inquiry the issuer did or did not conduct* or the *knowledge it did or did not have*—whose omission makes the opinion misleading to a reasonable person reading the statement fairly and in context. [*Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund* (2015) 575 US 175, 194-195, 135 S.Ct. 1318, 1332]

(8) [5:64] **Additional liability under Rule 10b-5:** Misstatements and omissions in the offering statement, if made with scienter, are also actionable as a violation of SEA § 10(b) of the 1934 Act and SEC Rule 10b-5 thereunder (*see ¶ 6:360 ff.*). Existence of the express remedy under SA § 11 does not preclude the implied remedy under Rule 10b-5, with its *longer* (2-year/5-year) statute of limitations (*¶ 6:375*). Thus, the purchaser can sue under either or both federal securities laws. [*Herman & Mac-Lean v. Huddleston* (1983) 459 US 375, 387, 103 S.Ct. 683, 690; see *Rubke v. Capitol Bancorp Ltd.* (9th Cir. 2009) 551 F3d 1156, 1164]

[5:64.1 - 5:64.4] ***Reserved.***

(9) [5:64.5] **Federal preclusion ("preemption") of state law class actions:** Federal law precludes certain state law securities class actions that are based on material misstatements or omissions in an offering. *See discussion at ¶ 6:375.5 ff.*

c. [5:65] **Civil liability for "fraud" in connection with registered offering (SA § 12(a)(2)):** The 1933 Act prohibits fraud (material misstatements or omissions) "by means of a prospectus …" Accordingly, to recover under § 12(a)(2), plaintiff must have been a purchaser in a distribution made by way of a registration statement and "prospectus" (as described in SA § 10 (15 USC § 77j)). [SA § 12(a)(2) (15 USC § 77*l*(a)(2)); *Gustafson v. Alloyd Co., Inc.* (1995) 513 US 561, 569-572, 115 S.Ct. 1061, 1067-1069—contract for private securities sale not a "prospectus" or "distribution" (hence no § 12(a)(2) liability)]

Caution: Fraud in connection with an unregistered offering is actionable under Rule 10b-5 of the 1934 Act. *See ¶ 6:360 ff.*

(1) [5:65.1] **Misleading statements and "half-truths" actionable:** Literally accurate statements may nonetheless be actionable if they mislead a reasonable investor through their context and manner of presentation. [*Miller v. Thane Int'l, Inc.* (9th Cir. 2008) 519 F3d 879, 886-889—prospectus' repeated statements that stock "has been approved" for listing

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

on Nasdaq mislead investors into believing stock would be listed; *Federal Housing Finance Agency v. Nomura Holding America, Inc.* (2nd Cir. 2017) 873 F3d 85, 140]

(a) [5:65.2] **No plaintiff's duty to investigate:** Stock purchasers do not have a "due diligence" duty to investigate or otherwise ascertain the truth of statements made in an offering (at least not where the statements, on their face, give no cause to believe they are untrue or misleading). [*Miller v. Thane Int'l, Inc.* (9th Cir. 2008) 519 F3d 879, 887; *see* ¶ *5:70a*]

[5:65.3 - 5:65.4] ***Reserved.***

(2) [5:65.5] **"Materiality" limitation:***See discussion at*¶ *5:58.1 ff.*

(3) [5:66] **Who may sue—direct purchasers only:** Only purchasers in *privity* with the issuer—i.e., purchasers in the *initial distribution* (as opposed to anyone to whom the purchasers may have resold)—have standing to sue. There is *no § 12(a)(2) liability* to persons who purchased securities in secondary market transactions or privately-negotiated resales. [*Gustafson v. Alloyd Co., Inc.* (1995) 513 US 561, 569-572, 115 S.Ct. 1061, 1067-1068; see also *Jensen v. iShares Trust* (2020) 44 CA5th 618, 649-650, 258 CR3d 1, 25-26—investors lacked standing to assert SA § 12(a)(2) claims because they purchased ETFs on secondary market, not directly from investment company]

(Compare: Liability for misstatements or omissions in a registration statement extends even to subsequent purchasers; *see*¶ *5:59*.)

(a) [5:66.1] **"Reliance" not part of prima facie case:** Plaintiff need not establish any actual reliance on the misrepresentation as an element of the prima facie claim under SA § 12(a)(2). [See *Miller v. Thane Int'l, Inc.* (9th Cir. 2008) 519 F3d 879, 886; *Wright v. National Warranty Co., L.P.* (6th Cir. 1992) 953 F2d 256, 262]

However, no § 12(a)(2) recovery will lie if defendant proves plaintiff in fact did not rely on the misrepresentation in making the investment (i.e., proof that P knew the statements were untrue; *see*¶ *5:70*).

(b) [5:66.2] **Compare—Rule 10b-5:** A SA § 12(a)(2) plaintiff need not satisfy the scienter, reliance and causation requirements of a claim under SEA § 10(b) (*see* ¶ *6:371 ff.*) and may recover rescissionary damages (not just actual damages). Thus, § 12(a)(2) is an important federal remedy alternative to § 10(b) and SEC Rule 10b-5 for persons who purchased securities from the issuer in a registered public offering. [See *In re Daou Systems, Inc., Secur. Litig.* (9th Cir. 2005) 411 F3d 1006, 1029 (abrogation on other grounds recognized by *Glazer Capital Mgmt., L.P. v. Forescout Technologies, Inc.* (9th Cir. 2023) 63 F4th 747, 766)—causation not essential element of § 12(a)(2) prima facie case; see also *New Jersey Carpenters Health Fund v. Royal Bank of Scotland Group, PLC* (2nd Cir. 2013) 709 F3d 109, 120; and *In re NVIDIA Corp. Secur. Litig.* (9th Cir. 2014) 768 F3d 1046, 1057—scienter not element of § 12(a)(2) claim]

(4) [5:67] **Who may be held liable:** The "seller" and anyone else who offers or sells a security through facilities of interstate commerce by oral or written communications that are "materially misleading" (misstatements or omissions of material facts) may be held liable. [SA § 12(a)(2) (15 USC § 77*l*(a)(2))]

(a) [5:68] **Privity of contract required:** Since the basis of liability is misrepresentation, defendant must be in *privity of contract* with plaintiff. This includes not only the corporate issuer or other transferor, but also brokers, dealers and other agents acting on the selling owner's behalf. Similarly, "control" persons (see SA § 15(a) (15 USC § 77***o***(a))) may be liable. [See *SEC v. Seaboard Corp.* (9th Cir. 1982) 677 F2d 1289, 1294-1295; *Hollinger v. Titan Capital Corp.* (9th Cir. 1990) 914 F2d 1564, 1576-1578—broker-dealer "controlled" registered representative under SA § 15; *Federal Housing Finance Agency v. Nomura Holding America, Inc.* (2nd Cir. 2017) 873 F3d 85, 99]

(b) [5:68.1] **Who are "sellers":** SA § 12 liability is limited to (i) the selling security owner; and (ii) persons who *solicit the sale* and were "motivated at least in part by a desire to serve … [their] own financial interests or those of the securities owner." This precludes from liability persons other than *actual sellers* (i.e., "aiders and abettors" and other *nonselling collateral participants*) even though their participation may have been a necessary and *substantial factor* in the fraudulent sale (e.g., promoters, officers, directors, etc.). [*Pinter v. Dahl* (1988) 486 US 622, 647, 108 S.Ct. 2063, 2078]

1) [5:68.2] **Comment:** Although the Supreme Court expressly limited its holding to SA § 12(a)(1), the circuit courts have consistently applied *Pinter* to the identical language of SA § 12(a)(2). [See *In re Daou Systems, Inc., Secur. Litig.* (9th Cir. 2005) 411 F3d 1006, 1029 (abrogation on other grounds recognized by *Glazer Capital Mgmt., L.P. v. Forescout Technologies, Inc.* (9th Cir. 2023) 63 F4th 747, 766); *Moore v. Kayport Package Express, Inc.* (9th Cir. 1989) 885 F2d 531, 536-537—lawyers and accountants performing professional services in connection with allegedly fraudulent offering had no "seller" liability under § 12(a)(2) since they did not solicit any purchases]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

The Supreme Court appears to have sanctioned this extension of *Pinter* to § 12(a)(2). [See *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* (1994) 511 US 164, 179, 185, 114 S.Ct. 1439, 1449, 1452, *discussed at*¶ *6:368.4*—§ 12 liability limited to securities sellers (dictum)]

(c) Defenses

1) [5:69] **Defendant's lack of knowledge:** Proof that defendant (i) did not know of the falsity; and (ii) could not reasonably have discovered it through the exercise of reasonable care, is a valid defense. But defendant bears the burden of proof on this matter. [SA § 12(a)(2) (15 USC § 77*l*(a)(2)); see *Federal Housing Finance Agency v. Nomura Holding America, Inc.* (2nd Cir. 2017) 873 F3d 85, 124-125, 129-131]

2) [5:70] **Plaintiff's knowledge:** It is also a valid defense to show that *plaintiff knew* of the untrue statement (i.e., no reliance on the false or omitted statement). But here, *plaintiff* bears the burden of proving they had *no actual knowledge* of the untrue statement. [SA § 12(a)(2) (15 USC § 77*l*(a)(2)); *Casella v. Webb* (9th Cir. 1989) 883 F2d 805, 809; *Federal Housing Finance Agency v. Nomura Holding America, Inc.* (2nd Cir. 2017) 873 F3d 85, 122]

a) [5:70a] **Compare—no imputed knowledge (contributory negligence) defense:** A purchaser has no duty to investigate a seller's possible fraud (*see* ¶ *5:65.2*). Thus, a showing by defendant that plaintiff "*should have known*" of the misrepresentation by exercising due care will *not* defeat recovery under SA § 12(a)(2). [*Casella v. Webb* (9th Cir. 1989) 883 F2d 805, 809; *Federal Housing Finance Agency v. Nomura Holding America, Inc.* (2nd Cir. 2017) 873 F3d 85, 122; *Wright v. National Warranty Co., L.P.* (6th Cir. 1992) 953 F2d 256, 262—purchaser/officer's access to accurate information did not create duty to verify issuer's statements]

[5:70b - 5:70c] *Reserved.*

3) [5:70d] **No loss causation:** Defendant is not liable for any portion of the security's diminution in value caused by something other than defendant's misrepresentation or omission. Here again, defendant bears the burden of proof. [SA § 12(b) (15 USC § 77*l*(b)); see *Miller v. Thane Int'l, Inc.* (9th Cir. 2010) 615 F3d 1095, 1104-1105—no loss causation where issuer's stock price increased in weeks following disclosure of information correcting prior misrepresentation that issuer's stock would be listed on major exchange; *Federal Housing Finance Agency v. Nomura Holding America, Inc.* (2nd Cir. 2017) 873 F3d 85, 99, 153; *and*¶ *5:62b* re loss causation defense under SA § 11]

4) [5:70.1] **"In pari delicto" defense:** Since the common law "in pari delicto" (equal culpability) defense is assertable in an action under the strict liability provisions of SA § 12(a)(1) (*see*¶ *5:73.3a*), the defense *might* also be available in a private action under SA § 12(a)(2).

(5) [5:71] **Scope of liability:** Plaintiff may either rescind their purchase and recover the full amount paid (with interest, less any income received); or, if the shares have already been sold, may recover the amount lost on the investment. [See SA § 12(a) (15 USC § 77*l*(a)); see *Federal Housing Finance Agency v. Nomura Holding America, Inc.* (2nd Cir. 2017) 873 F3d 85, 98-99]

(a) [5:71.1] **No offset for tax benefits upon rescission:** A defrauded investor who *rescinds* a purchase may recover the full amount paid *regardless* of any *tax* benefits obtained from the investment … even if this places the investor in a better position than if there had been no fraud.

Rationale: Tax benefits do *not* constitute either a "return of consideration" or "income received" by the investor. Thus, they may *not* be deducted from damages obtainable under SA § 12(a)(2) (or when calculating similar *rescissionary damages* under SEA § 10(b) and SEC Rule 10b-5; ¶ *6:373 ff.*). [*Randall v. Loftsgaarden* (1986) 478 US 647, 656-657, 664, 106 S.Ct. 3143, 3149, 3153]

1) [5:71.2] **Delay as bar to rescission?** Since there is no offset for tax benefits, plaintiffs may be tempted to wait until they have received the bulk of their tax benefits from tax shelter investments before rescinding the purchase and asserting claims under SA § 12. However, the U.S. Supreme Court has suggested (but not ruled) that to combat such abuses courts may *bar* plaintiffs from electing rescission or a rescissionary measure of damages. (This has already been done in SEC Rule 10b-5 cases; see *Baumel v. Rosen* (4th Cir. 1969) 412 F2d 571, 573-575.) [*Randall v. Loftsgaarden* (1986) 478 US 647, 666, 106 S.Ct. 3143, 3154]

2) [5:71.3] **Compare—damages claims:** Where, instead of rescinding, the investor sues for *damages*, tax benefits may constitute an offset (since "*out of pocket*" loss is the measure of damages in most cases—e.g., in most SEC

Rule 10b-5 cases, ¶ *6:373.1*). This would be especially true where the investment was sold to provide substantial tax benefits, and in fact did so. [*Randall v. Loftsgaarden* (1986) 478 US 647, 667-670, 106 S.Ct. 3143, 3155-3156 (see J. Blackmun, concur.opn.); and see *Salcer v. Envicon Equities Corp.* (2nd Cir. 1984) 744 F2d 935, 941-944, cert.grntd. (1986) 478 US 1015, remanded in light of *Randall v. Loftsgaarden*, supra; also see *DCD Programs, Ltd. v. Leighton* (9th Cir. 1996) 90 F3d 1442, 1446-1451—damages may not include expected tax benefits subsequently disallowed by IRS]

(b) [5:71.4] **Contribution and indemnification among defendants:** Under the federal securities laws, claims for indemnification among joint violators are treated differently than contribution claims:

1) [5:71.5] **Indemnification claims:** Neither the 1933 Act nor the 1934 Act *expressly* recognizes any right to indemnification. Not finding any congressional intent to create such a right, federal courts have uniformly *refused* to *imply* any indemnity rights because doing so would allow unsuccessful defendants in a securities action to escape loss by shifting their entire responsibility to another, thereby frustrating the statutes' goal of encouraging diligence in securities transactions. [See, e.g., *Laventhol, Krekstein, Horwath & Horwath v. Horwitch* (9th Cir. 1980) 637 F2d 672, 676; *King v. Gibbs* (7th Cir. 1989) 876 F2d 1275, 1279-1282]

Compare: The federal securities laws do not prohibit a corporation (or its insurer) from indemnifying directors and officers for expenses and amounts paid in settlement of nonwillful securities violations. [*Raychem Corp. v. Federal Ins. Co.* (ND CA 1994) 853 F.Supp. 1170, 1176-1177, 1179-1180]

2) [5:71.6] **Contribution claims:** In contrast to indemnification, which is rejected on policy grounds as eliminating liability and weakening deterrence (¶ 5:71.5), contribution is viewed as sharing liability and encouraging diligence and compliance by all defendants. Indeed, SA § 11 expressly creates a right of contribution among all those held liable thereunder (¶ *5:62.1*). Moreover, the U.S. Supreme Court has recognized contribution claims in the analogous area of SEC Rule 10b-5 fraud actions. It would thus appear that contribution among joint wrongdoers is likewise permitted under SA § 12(a)(2) (though there is no definitive judicial authority on this issue). [See *Musick, Peeler & Garrett v. Employers Ins. of Wausau* (1993) 508 US 286, 295-298, 113 S.Ct. 2085, 2090-2092—contribution permitted under Rule 10b-5 (effectively mooted by SEA § 21D(f)(8) allowing contribution based on "percentage of responsibility" in 1934 Act claims; *see*¶ *6:374c*); also see M. Steinberg & C. Olive, "Contribution and Proportionate Liability Under the Federal Securities Laws in Multidefendant Securities Litigation After the Private Securities Litigation Reform Act of 1995," 50 SMU L.Rev. 337, 382 (1996); but see *Baker, Watts & Co. v. Miles & Stockbridge* (4th Cir. 1989) 876 F2d 1101, 1104-1106 (predating *Musick*)—no contribution right under SA § 12(a)(2)]

a) [5:71.7] **Comment:** The right to contribution may both encourage and impede settlement. While contribution permits defendants to avoid bearing a disproportionate share of liability, it denies them the ability to resolve *all potential liability* to others through negotiations with the plaintiff.

3) [5:71.8] **Preemption of state laws:** At least one circuit court has determined that federal securities laws *preempt* pendent state law claims for *indemnification*, but *not* those for *contribution*. [See *Baker, Watts & Co. v. Miles & Stockbridge* (4th Cir. 1989) 876 F2d 1101, 1107-1108]

(c) [5:71.9] **No statutory attorney fees:** Unlike SA § 11, which grants attorney fees to the party who prevails against a meritless claim or defense (¶ *5:62.2 ff.*), SA § 12 contains *no* provision for recovery of attorney fees.

(But attorney fees may be awarded under SA § 27; *see*¶ *5:62.4 ff.*)

1) [5:71.10] **Fee-shifting by agreement:** The parties may agree among themselves to a prevailing party attorney fee award. However, courts tend to construe such provisions narrowly. [See *Layman v. Combs* (9th Cir. 1992) 994 F2d 1344, 1350-1353—agreement to indemnify issuer against purchasers' misrepresentations in private placement interpreted to apply only to untruths relating to investor suitability standards]

(6) [5:72] **One-year/three-year statute of limitations:** Actions under SA § 12(a)(2) must be brought within *one year* after plaintiff *discovered*, or through the "exercise of reasonable diligence" *should have discovered*, the false statement, but in any event *no later than three years* after the *sale*. [SA § 13 (15 USC § 77m)]

(a) [5:72.1] **Three-year period—no "integration" of sales:** The three-year period applies *separately to each sale*. A sale occurring more than three years before suit is filed cannot be "saved" by being linked to another sale within the three-year period … even when the sales are closely related. This is so whether the sales are made to the same or different investors. [*Caviness v. Derand Resources Corp.* (4th Cir. 1993) 983 F2d 1295, 1299-1301]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) [5:72.2] **Three-year period not tolled by fraudulent concealment:** Unlike the one-year period, which is determined by the plaintiff's personal circumstances (actual or constructive discovery of the fraud, *¶ 5:72*), the three-year period runs from an objectively-determinable fixed date—i.e., the "sale." Fraudulent statements designed to lull plaintiff into complacency do not estop defendant from asserting the statute. [*Caviness v. Derand Resources Corp.* (4th Cir. 1993) 983 F2d 1295,1300-1302; see *Police & Fire Retirement System of City of Detroit v. IndyMac MBS, Inc.* (2nd Cir. 2013) 721 F3d 95, 107—3-year limitations period is absolute and not subject to equitable tolling]

[5:72.3 - 5:72.4] ***Reserved.***

(c) [5:72.5] **One-year period commenced by "inquiry notice"?** Courts have held that the one-year limitations period begins to run when plaintiff becomes aware of facts that would lead a reasonable person to *investigate further* and thereby discover the misrepresentation ("inquiry notice"). [See *Great Rivers Co-op. of Southeastern Iowa v. Farmland Indus., Inc.* (8th Cir. 1997) 120 F3d 893, 896-897; see *Davis v. Birr, Wilson & Co., Inc.* (9th Cir. 1988) 839 F2d 1369, 1370]

However, later cases conclude that the Supreme Court's decision in *Merck & Co., Inc. v. Reynolds* (2010) 559 US 633, 644-651, 130 S.Ct. 1784, 1793-1797 (*see¶ 6:375.2c*), which eschewed "inquiry notice" with respect to the statute of limitations governing SEC Rule 10b-5 actions (28 USC § 1658(b)), compels rejection of "inquiry notice" in SA § 13 cases. [*Federal Housing Finance Agency v. Nomura Holding America, Inc.* (2nd Cir. 2017) 873 F3d 85, 119-120 & fn. 37; *Pension Trust Fund for Operating Engineers v. Mortgage Asset Securitization Transactions, Inc.* (3rd Cir. 2013) 730 F3d 263, 272-275]

(d) [5:72.6] ***Two*-year/*five*-year limitations period applicable?**28 USC § 1658(b), § 804 of the Sarbanes-Oxley Act of 2002 enacted by, provides that "a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws" may be brought within *two years* after discovery of the facts constituting the violation, but not more than *five years* after the violation. [28 USC § 1658(b)]

This two-year/five-year limitations period clearly applies to actions brought under SEC Rule 10b-5 (*see ¶ 6:375*). The Second Circuit has ruled that this limitations period also applies to actions brought under SEA §§ 9(f) and 18(a), but not to actions brought under SEA § 14(a) (proxy statement misstatements and omissions), because actions under SEA §§ 9(f) and 18(a) involve fraud and deceit whereas actions under SEA § 14(a) do not require plaintiffs to allege fraud or scienter (negligence suffices to establish liability). [*Dekalb County Pension Fund v. Transocean Ltd.* (2nd Cir. 2016) 817 F3d 393, 401-409; see *In re Exxon Mobil Corp. Secur. Litig.* (3rd Cir. 2007) 500 F3d 189, 196-198—28 USC § 1658(b) not applicable to SEA § 14(a) claims; *Blaz v. Belfer* (5th Cir. 2004) 368 F3d 501, 503—28 USC § 1658(b) applies to SEA § 18(a) claims]

SA § 12(a)(2) claims need not allege or prove scienter. Hence, these claims should be governed by the SA § 13 limitations period (one-year/three-year) and not the 28 USC § 1658(b) limitations period.

(7) [5:73] **Additional liability under Rule 10b-5:** Again, the same conduct, if committed with scienter, may be actionable under § 10(b) of the 1934 Act and SEC Rule 10b-5 thereunder (*¶ 6:360 ff.*), with its *longer* (2-year/5-year) statute of limitations (*¶ 6:375*). Rule 10b-5 extends to any security, registered or unregistered, exempt or nonexempt. [*Berger v. Bishop Investment Corp.* (8th Cir. 1982) 695 F2d 302, 306-307]

(8) [5:73a] **Federal preclusion ("preemption") of state law class actions:** Federal law precludes certain state law securities class actions that are based on material misstatements or omissions in an offering. *See discussion at¶ 6:375.5 ff.*

d. [5:73.1] **Civil liability for selling unregistered securities (SA § 12(a)(1)):** The 1933 Act prohibits securities from being sold or offered for sale unless they are registered or exempt from registration; and imposes civil liability for violation of these provisions. [SA § 12(a)(1) (15 USC § 77*l*(a)(1))]

(1) [5:73.2] **Who may be held liable:** SA § 12(a)(1) liability extends only to the "seller" (i.e., actual transferor of title) and any other person "who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." This *includes* corporate agents, officers and employees involved in selling the unregistered securities, but *excludes* "aiders and abettors" and other *nonselling collateral participants*—even if they were a "substantial factor" in bringing about the sale. [*Pinter v. Dahl* (1988) 486 US 622, 648-649, 108 S.Ct. 2063, 2079; see *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* (1994) 511 US 164, 179, 184, 114 S.Ct. 1439, 1449,

1452—no "aider and abettor" liability under 1933 Act (dictum); see also *Craftmatic Secur. Litig. v. Kraftsow* (3rd Cir. 1990) 890 F2d 628, 634-637]

(a) [5:73.2a] **Compare—SEC enforcement actions:** Liability may be broader in an SEC enforcement action (*see*¶ *5:74 ff.*) seeking civil penalties or other remedies in connection with the sale of unregistered securities in violation of SA § 5: Liability arising from the sale may extend to a nonseller who was a "substantial factor" (and also a "necessary participant") in the sale. (Whether a nonseller was a "substantial factor" in the violation is often a *factual* issue requiring analysis of the securities scheme and their participation in it.) [*SEC v. CMKM Diamonds, Inc.* (9th Cir. 2013) 729 F3d 1248, 1255-1261 & fn. 5—disgorgement remedy applies to transfer agent who effected transfers of unregistered shares if found to be "substantial factor" in SA § 5 violation (noting "*Pinter* did not overrule use of the substantial factor test for purposes of imposing Section 5 liability")]

(2) [5:73.3] **Strict liability for violations:** A seller is strictly liable for failure to register a nonexempt offering. Lack of knowledge or intent or a showing of good faith inadvertence or reliance upon counsel is no defense. Nor is it a defense that the purchaser-plaintiff was a sophisticated investor who did not need the protections of the securities laws. [*Federal Housing Finance Agency v. Nomura Holding America, Inc.* (2nd Cir. 2017) 873 F3d 85, 99; see *Pinter v. Dahl* (1988) 486 US 622, 638, 108 S.Ct. 2063, 2074; *Sagehorn v. Engle* (2006) 141 CA4th 452, 459, 46 CR3d 131, 134; see also *SEC v. CMKM Diamonds, Inc.* (9th Cir. 2013) 729 F3d 1248, 1256-1257 & fn. 6—strict liability likewise applies in SEC enforcement action for sale of unregistered securities in violation of SA § 5 (no showing of "scienter" required)]

(a) [5:73.3a] **"In pari delicto" defense may prevent recovery:** However, the "in pari delicto" defense may prevent plaintiff's recovery if:

- Plaintiff's role in buying the unregistered, nonexempt securities was more as a *promoter* than as an *investor* (i.e., plaintiff bought for the purpose of redistributing the securities);
- Plaintiff bore "*at least substantially equal responsibility*" for the failure to register the securities or sell them under an exemption; and
- Precluding plaintiff's suit "would *not significantly interfere* with the effective enforcement of the securities laws and protection of the investing public." [*Pinter v. Dahl* (1988) 486 US 622, 633-640, 108 S.Ct. 2063, 2071-2074 (emphasis added)]

(3) [5:73.4] **Measure of damages:** Plaintiff may recover the same damages as in suits for fraud under SA § 12(a)(2) (¶ *5:71 ff.*).

(4) [5:73.5] **Statute of limitations:** An action alleging a sale of securities in violation of the SA § 12(a)(1) registration requirement must be brought within *one year* after the violation and in no event more than *three years* after the first "bona fide" public offer of the security. [SA § 13 (15 USC § 77m); *P. Stolz Family Partnership L.P. v. Daum* (2nd Cir. 2004) 355 F3d 92, 100-106; see *Raiford v. Buslease, Inc.* (11th Cir. 1987) 825 F2d 351, 355—1-year period commences upon "use of the mail or interstate commerce to complete any integral stage of the sale of an unregistered security, including remittance of the funds for the purchase"]

(a) [5:73.6] **No equitable tolling:** Equitable tolling, which halts the running of the statute of limitations during the time defendant fraudulently concealed the operative facts from plaintiff, does not apply to the SA § 13 one-year limitations period. An SA § 12(a)(1) action is based upon failure to register, and a diligent plaintiff's search of the SEC's public records would have disclosed the fact of nonregistration. [*Sagehorn v. Engle* (2006) 141 CA4th 452, 460-463, 46 CR3d 131, 135-137; *Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 247-249, 70 CR3d 199, 216-218]

e. [5:73.7] **Concurrent federal/state court jurisdiction over 1933 Act claims:** An action arising under the 1933 Act may be brought in federal or state court. An action brought in state court—other than a "covered class action" involving a "covered security" (¶ *6:375.6 ff.*)—may *not be removed* to federal court. [SA §§ 16(c), 22(a) (15 USC §§ 77p(c), 77v(a)); see *Luther v. Countrywide Fin'l Corp.* (2011) 195 CA4th 789, 794-797, 125 CR3d 716, 719-721; *Luther v. Countrywide Home Loans Servicing LP* (9th Cir. 2008) 533 F3d 1031, 1034—Class Action Fairness Act of 2005 permitting removal of certain class actions exceeding $5 million in controversy does not supersede SA § 22(a) bar to removal of 1933 Act cases]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

f. [5:73.8] **Release of securities law claims:** Parties may agree to release securities law claims they *actually know* to exist. However, a release of *unknown* claims is generally *unenforceable* on the theory it constitutes an impermissible waiver of remedies created by the securities laws. [See SEA § 29(a) (15 USC § 78cc(a))—voiding "any condition, stipulation, or provision binding any person to waive compliance" with 1934 Act; *Burgess v. Premier Corp.* (9th Cir. 1984) 727 F2d 826, 831-832]

(1) [5:73.9] **Exception for *postdispute release:*** The general rule prohibiting a release of unknown claims does *not* apply if the release is given as part of a settlement of ongoing litigation where the parties intend to resolve all actual *and potential* claims among themselves. To hold otherwise would discourage settlement of disputes in which a federal securities claim could eventually be discovered. [*Petro-Ventures, Inc. v. Takessian* (9th Cir. 1992) 967 F2d 1337, 1340-1342]

g. [5:74] **Liability for fraudulent securities transactions (SA § 17):** It is unlawful for any person in the offer or sale of any security *willfully* to:

• Employ any "device, scheme or artifice to defraud";

• Obtain money or property by means of any untrue statement or omission of a material fact; or

• Engage in any transaction, practice or course of business "which operates as a fraud or deceit" upon the purchaser. [SA § 17(a) (15 USC § 77q(a)); see *SEC v. Feng* (9th Cir. 2019) 935 F3d 721, 734; *SEC v. Stein* (9th Cir. 2018) 906 F3d 823, 829-830; *United States v. English* (9th Cir. 1996) 92 F3d 909, 914-916; also see 18 USC § 1348 (fraud in connection with securities of 1934 Act reporting companies)]

(1) [5:74.1] **SEC enforcement actions and criminal prosecution:** The SEC may seek various remedies, such as injunctions, disgorgement orders (¶ 5:74.2), asset freezes, receivership orders and monetary penalties, against persons who violate SA § 17(a) (¶ 5:74), as well as any other persons who *knowingly or recklessly* aid and abet. The SEC may also refer matters to the Attorney General for criminal prosecution. [SA §§ 8A, 15(b), 20(b), (d) (15 USC §§ 77h-1, 77***o***(b), 77t(b), 77t(d)); see *Kokesh v. SEC* (2017) 581 US 455, 458-459, 137 S.Ct. 1635, 1640; *SEC v. Feng* (9th Cir. 2019) 935 F3d 721, 737; *SEC v. World Capital Market, Inc.* (9th Cir. 2017) 864 F3d 996, 1003; *SEC v. M & A West, Inc.* (9th Cir. 2008) 538 F3d 1043, 1054-1055]

(a) [5:74.2] **Disgorgement:** Disgorgement may be awarded as an equitable remedy under 15 USC § 78u(d)(5), as long as the award does not exceed the wrongdoer's net profits and is awarded "for victims." [*Liu v. SEC* (2020) _ US _, _, 140 S.Ct. 1936, 1940]

1) [5:74.3] **Factors restricting disgorgement awards:** Although it ruled that disgorgement is generally permissible (¶ 5:74.2), the Supreme Court did not decide several narrower issues in *Liu* that affect whether or not disgorgement is lawful in a particular case. [*Liu v. SEC* (2020) _ US _, 140 S.Ct. 1936, 1947]

The Court, however, provided guidance on how to assess these issues on remand and identified factors that should be considered in determining the lawfulness of a disgorgement award:

• [5:74.4] *Failure to return funds to victims:* The Court noted that the SEC "does not always return the entirety of disgorgement proceeds to investors," and instead deposits a portion of the proceeds it collects into a fund that is used to pay whistleblowers and fund the Inspector General's activities. While conceding that the permissibility of the SEC's practice remains "an open question," the Court advised that "the SEC's equitable, profits-based remedy must do more than simply benefit the public at large by virtue of depriving a wrongdoer of ill-gotten gains." [*Liu v. SEC* (2020) _ US _, 140 S.Ct. 1936, 1947-1949]

• [5:74.5] *Joint and several liability:* The Court advised that the SEC's practice of imposing joint-and-several liability on a wrongdoer's affiliates "could transform any equitable profits-focused remedy into a penalty." However, the Court also explained that the common law permitted joint-and-several liability "for partners engaged in concerted wrongdoing." While it did not decide the joint-and-several liability issue in *Liu*, the Court highlighted numerous facts that would support finding the defendants jointly and severally liable. Namely, the Court noted that the defendants were married; both spouses were apparently involved with the underlying businesses; neither spouse was a "passive recipient of profits"; the finances were commingled; and both spouses enjoyed "the fruits of the scheme." [*Liu v. SEC* (2020) _ US _, 140 S.Ct. 1936, 1949]

• [5:74.6] *Deducting business expenses:* The Court explained that courts "must deduct legitimate expenses before ordering disgorgement," except if the expenses "were incurred for the purposes of furthering an entirely fraudulent scheme." While it did not decide the issue in *Liu*, the Court noted that some of the defendants' expenses were for lease payments and cancer-treatment equipment, which "arguably have value independent of fueling a fraudulent scheme." [*Liu v. SEC* (2020) _ US _, 140 S.Ct. 1936, 1950]

(2) [5:75] **No implied civil liability:** The SA § 17 provisions do *not* provide a basis for implied civil liability under which private persons can sue for damages. [*In re Washington Pub. Power Supply Systems Secur. Litig.* (9th Cir. 1987) 823 F2d 1349, 1353-1358; *Maldonado v. Dominguez* (1st Cir. 1998) 137 F3d 1, 6-8; *Finkel v. Stratton Corp.* (2nd Cir. 1992) 962 F2d 169, 174-175]

(3) [5:75.1] **Five-year limitations period on action seeking civil penalties:** The 1933 Act does not contain any limitations period on SEC enforcement actions. Such actions are governed by 28 USC § 2462, which provides that any action "for the enforcement of any civil fine, penalty, or forfeiture" must be brought within *five years* "from the date when the claim first accrued." [*Kokesh v. SEC* (2017) 581 US 455, 465, 137 S.Ct. 1635, 1644—§ 2462 5-year limitations period also applies to SEC actions seeking disgorgement; *Gabelli v. SEC* (2013) 568 US 442, 447-451, 133 S.Ct. 1216, 1220-1223—§ 2462 5-year limitations period begins when fraud was *committed* and not later when fraud was *discovered; also see ¶ 6:375.3a ff.*]

(4) [5:75.1a] **Right to jury trial in SEC enforcement actions:***See ¶ 6:374.5*.

h. [5:75.2] **Compare—statutory bar to civil RICO liability:** Conduct actionable as fraud in the purchase or sale of securities can give rise to civil liability under the Racketeer Influenced and Corrupt Organizations Act (18 USC §§ 1961-1968), which authorizes treble damages plus reasonable attorney fees, *only* against persons *criminally convicted* in connection with the fraud. [18 USC § 1964(c); see *Powers v. Wells Fargo Bank NA* (9th Cir. 2006) 439 F3d 1043, 1045; *Bald Eagle Area School Dist. v. Keystone Fin'l, Inc.* (3rd Cir. 1999) 189 F3d 321, 327-330—prohibition on RICO securities fraud suits cannot be avoided by couching action as mail, wire or bank fraud; *Swartz v. KPMG LLP* (9th Cir. 2007) 476 F3d 756, 761]

[5:75.3 - 5:75.12] ***Reserved.***

i. [5:75.13] **Predispute arbitration agreements:** Agreements to arbitrate *future* disputes relating to the purchase of securities are fully enforceable. [*Rodriguez de Quijas v. Shearson/American Express, Inc.* (1989) 490 US 477, 480, 109 S.Ct. 1917, 1920 (arbitration of 1933 Act claims); *Shearson/American Express, Inc. v. McMahon* (1987) 482 US 220, 232-233, 107 S.Ct. 2332, 2341 (arbitration of 1934 Act claims); see *Rosenthal v. Great Western Fin'l Secur. Corp.* (1996) 14 C4th 394, 405-407, 58 CR2d 875, 880-881]

(1) [5:75.14] **Contract principles govern:** Private agreements to arbitrate are enforced according to their terms; and, generally, a securities arbitration agreement is governed by the same principles applicable to the interpretation of any other contract. [See *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Jr. Univ.* (1989) 489 US 468, 479, 109 S.Ct. 1248, 1256; *Rosenthal v. Great Western Fin'l Secur. Corp.* (1996) 14 C4th 394, 410, 58 CR2d 875, 883-884]

• [5:75.14a] Thus, a standard form brokerage agreement containing an arbitration provision that was ambiguous (and arguably deceptive) on the issue of the arbitrator's authority to award *punitive* damages was interpreted against the party who drafted the agreement (i.e., punitive damage award against broker upheld). [*Mastrobuono v. Shearson Lehman Hutton, Inc.* (1995) 514 US 52, 57-63, 115 S.Ct. 1212, 1216-1219]

• [5:75.14b] An arbitration provision in a brokerage agreement was enforceable by a financial advisor who signed the agreement as the broker's "registered representative." By its express terms, the arbitration provision applied to the broker's "agents," and the financial advisor was acting as the broker's agent. Additionally, the financial advisor could enforce the arbitration provision as a third party beneficiary. [*Ronay Family Ltd. Partnership v. Tweed* (2013) 216 CA4th 830, 837-845, 157 CR3d 680, 684-691 (also finding fact that broker subsequently became defunct and hence could not enforce arbitration provision under certain FINRA rules (*see¶ 5:75.16*) did not bar enforcement by financial advisor because cited rules did not apply to financial advisor)]

(2) [5:75.14c] **Enforcement by nonsignatory:** Under the doctrine of equitable estoppel, a party who is not a signatory to an arbitration agreement may compel arbitration against a party who is a signatory to the agreement if the signatory's claims against the nonsignatory rely on the agreement's terms. [*GE Energy Power Conversion France SAS, Corp. v. Outokumpu Stainless USA, LLC* (2020) _ US _, _, 140 S.Ct. 1637, 1644, 1648—international "Convention on the

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Recognition and Enforcement of Foreign Arbitral Awards" does not displace domestic-law equitable estoppel doctrine allowing nonsignatories to enforce arbitration agreements against signatories]

(3) [5:75.15] **Scope of arbitrable issues:** Absent evidence of contrary intent, the parties are presumed to have intended arbitration of *all* issues. Thus, a claim that the agreement as a whole was obtained through fraud (e.g., "fraud permeating the transaction") is arbitrable. [*Rosenthal v. Great Western Fin'l Secur. Corp.* (1996) 14 C4th 394, 412-416, 58 CR2d 875, 885-887]

However, arbitration will *not* be compelled where a party's *consent* to or *execution* of the agreement was obtained by fraud. "If the entire contract is void *ab initio* because of fraud, the parties have not agreed to arbitrate any controversy." Such claims of "fraud in the inducement" are to be decided by the *court* in ruling upon a petition to compel arbitration. [*Rosenthal v. Great Western Fin'l Secur. Corp.* (1996) 14 C4th 394, 415-416, 58 CR2d 875, 887-888; see *Rodriguez de Quijas v. Shearson/American Express, Inc.* (1989) 490 US 477, 483-484, 109 S.Ct. 1917, 1921]

Nor will arbitration be compelled where the agreement does not cover the dispute in question (i.e., parties did not agree to arbitrate the particular matter) or where the moving party lacks standing to compel arbitration (i.e., not a party to the agreement). [See *Paulson v. Dean Witter Reynolds, Inc.* (9th Cir. 1990) 905 F2d 1251, 1254; *Britton v. Co-op Banking Group* (9th Cir. 1990) 916 F2d 1405, 1413 (abrogated on other grounds by *Coinbase, Inc. v. Bielski* (2023) 599 US 736, 143 S.Ct. 1915)]

(4) [5:75.16] **Self-regulatory organizations' response:** Investor concerns have led the Financial Industry Regulatory Authority (FINRA) (formerly the National Association of Securities Dealers) and various stock exchanges to implement a number of rules ensuring the fairness of arbitration agreements and procedures, including:

- Mandatory disclosures within agreements explaining the effect of arbitration clauses;
- Prohibition on language that limits arbitrators' abilities to make awards;
- Discovery procedures;
- Prohibition on arbitration of class action claims; and
- Arbitrator disclosure requirements. [See FINRA Rules 2268, 12204, 12405, 12408; NYSE Rules 600, 610, 619, 636]

[5:75.17] ***Reserved.***

(5) [5:75.18] **Collateral estoppel and res judicata effect of arbitration award:***All grounds for recovery* that *could have been* asserted (whether or not actually asserted) in the arbitration proceeding may be barred in a subsequent suit between the same parties on the same cause of action ("res judicata" or "claim preclusion"). [See *Clark v. Bear Stearns & Co., Inc.* (9th Cir. 1992) 966 F2d 1318, 1320]

Relitigation in a subsequent suit of an *issue* actually decided in the arbitration may be precluded ("collateral estoppel" or "issue preclusion") if (a) the issue is *identical* in both proceedings, (b) the issue was *actually arbitrated* to an award, and (c) determination of the issue was a "critical and necessary part" of the award. [See *Clark v. Bear Stearns & Co., Inc.*, supra]

(a) [5:75.19] **Burden of proof:** The award is binding upon the parties to the extent of the issues submitted to arbitration. The party asserting issue or claim preclusion in a subsequent suit must show "with clarity and certainty" what was determined by the arbitration award. To do so, the party must produce a sufficient record of the arbitration proceeding to enable the court to pinpoint the *exact issues* previously arbitrated. [*United States v. Lasky* (9th Cir. 1979) 600 F2d 765, 769; *Clark v. Bear Stearns & Co., Inc.* (9th Cir. 1992) 966 F2d 1318, 1321]

(b) [5:75.20] **Application:** Customer sued Broker, alleging various violations of federal securities laws, fraud, breach of fiduciary duty, negligence and conversion. The court ordered all claims to arbitration, *except* the federal securities claims. The resulting award dismissed "all claims" against Broker, and Broker sought to invoke the award to preclude *all* claims in the lawsuit.

Claim preclusion was not proper. Since the arbitration panel had no subject matter jurisdiction over the federal claims, they were not claims that "could have been asserted" in the arbitration. Issue preclusion was likewise improper; Broker

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

failed to meet the burden of proof by neglecting to file a transcript of the arbitration or otherwise indicating what evidence had been submitted to the panel. [*Clark v. Bear Stearns & Co., Inc.* (9th Cir. 1992) 966 F2d 1318, 1321; see *Wolf v. Gruntal & Co., Inc.* (1st Cir. 1995) 45 F3d 524, 529-530—arbitration award on state law claims against securities broker did not have res judicata effect precluding concurrent SEC Rule 10b-5 claim brought in federal court because parties' agreement excluded federal securities law claims from arbitration]

[5:75.21 - 5:75.24] ***Reserved.***

(6) [5:75.25] **Compare—customer's right to arbitrate dispute with broker, dealer or underwriter:** A customer of a member of the Financial Industry Regulatory Authority (¶ 5:75.16) has a right to compel arbitration of a dispute arising out of the member's business activities. [FINRA Rule 12200]

This includes a dispute between a securities issuer and its underwriter. However, the issuer may by agreement effectively waive or disclaim the arbitration right. [See *Goldman Sachs & Co. v. City of Reno* (9th Cir. 2014) 747 F3d 733, 739-741—underwriting agreement provision selecting Nevada federal district court as forum for resolving disputes demonstrated parties' intent to disclaim arbitration]

Cross-refer: For a detailed discussion of contractual arbitration under state and federal law, see Knight, Chernick, Quinn & Gupta, *Cal. Prac. Guide: Alternative Dispute Resolution* (TRG), Ch. 5.

5. Exemptions From Federal Registration Requirement

a. Introduction—importance of finding an exemption

(1) [5:76] **Time and cost of registration:** Registering an issue with the SEC is both time-consuming and expensive. It frequently takes several months to prepare, submit and amend the registration statement before the SEC will allow it to "become effective." Often the fees charged by attorneys, accountants, printers, etc. for even a relatively routine registration well exceed $250,000. Moreover, the issuer becomes subject to the periodic reporting requirements of SEA § 13 at least for the remainder of its fiscal year (*see ¶ 5:56.6*), thus adding to the costs. So whenever possible, attorneys usually attempt to structure the securities issuance to fit within one or more of the exemptions (¶ 5:81 ff.).

(2) [5:77] **Potential liabilities in connection with registration statement or prospectus:** Finding an appropriate exemption from registration also serves to avoid any potential liability for "material misstatements or omissions" in the registration statement or prospectus. [SA §§ 11 (15 USC § 77k; *¶ 5:58*), 12(a)(2) (15 USC § 77*l*(a)(2); *¶ 5:65*)]

(a) [5:78] **Caution—Rule 10b-5 antifraud provisions still applicable:** But even an exempt issuance is subject to the SEC Rule 10b-5 antifraud provisions; *see¶ 6:360 ff.*

(3) [5:79] **Potential liability for selling unregistered securities:** If the shares are *not* registered, the importance of establishing an exemption cannot be overemphasized. Absent an applicable exemption, purchasers of unregistered securities have the absolute *right to rescind* the transaction and recover their entire investment (with interest). They do *not* have to prove fraud or material misstatements or omissions. The simple fact that the securities are unregistered and not exempt from the registration requirement *entitles investors to change their mind* and recover their investment any time before the applicable statute of limitations runs. [SA § 12(a)(1) (15 USC § 77*l*(a)(1)); *see ¶ 5:73.1*] (The result is the same under the California statute; see Corps.C. § 25503, ¶ 5:359.)

(a) [5:80] **Comment:** Needless to say, the threat is ominous. Until the statute of limitations runs (which could be up to three years after the securities were issued; *see¶ 5:73.5*), the issuer could be forced to disgorge some or all of its capital … and effectively be driven out of business. (To avoid the risk, the company would have to become so successful that the investors would not want their money back.)

SUMMARY COMPARISON OF MAJOR FEDERAL AND STATE EXEMPTIONS

[Ed. Note: Other significant exemptions, not reproduced here, include the federal intrastate offerings exemption (Rules 147 and 147A), discussed at ¶ 5:81 ff.]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

FEDERAL					CALIFORNIA		
	CROWD-FUNDING	RULE 504	RULE 506 (PREEMPTS STATE REGS.)	REG. A	§ 25102(F)	§ 25102(H)	§ 25102(N) (UP TO $5 MIL. EXEMPT FROM FED. REG.)
Maximum exemption	$5,000,000 12 mos.	$10,000,000	Unlimited	$75,000,000	Unlimited	Unlimited	Unlimited
Issuers who may claim exemption	Any U.S. except “SEC reporting,” “blank check” or regis. investment companies (¶ *5:106.4*)	Any except “SEC reporting,” “blank check” or regis. investment companies (¶ *5:110*)	Any	Any	Any	Corporation with only one class of voting common stock (¶ *5:225*)	Cal. or “pseudo-foreign” corps, other than “blank check” or “rollup” issuers (¶ *5:304.23*)
Purchaser qualifications	Dollar limits based on purchaser's income/net worth (¶ *5:106.5 ff.*)	None	Financial and business experience under 506(b) (¶ *5:173*); “accredited” investors under 506(b) or (c) (¶ *5:181*)	None	“Counted” purchasers must have pre-existing relationship; or financial and business experience (¶ *5:278*)	None	Financial and business experience, plus adequate net worth (¶ *5:304.10*)
Maximum number of purchasers	None	None	35 + “excluded” investors (below) under 506(b); unlimited “accredited” investors under 506(c)	None	35 + any “excluded” investors	35 (¶ *5:229*)	None
Treated as single purchaser	N/A	N/A	Spouses; relatives in same household; 50% owned entities (¶ *5:174.12*)	N/A	Spouses; relatives in same household; 50% owned entities (¶ *5:262 ff.*)	Spouses (¶ *5:230*)	N/A
Excluded investors	N/A	N/A	“Accredited” investors (¶ *5:174 ff.*) under Rule 506(b)	None	Institutional investors (¶ *5:266*) Directors,	None	N/A

			(¶ *5:173*) N/ A under Rule 506(c) (¶ *5:181*)		officers and other policymakers (¶ *5:267*) Promoters (¶ *5:271*) $150,000 purchasers (who meet certain qualifications) (¶ *5:272*) “Accredited” investors (¶ *5:275*) Wholly-owned entities (¶ *5:276*)		
Types of securities which may be issued	No limit	No limit	No limit	No limit	No limit	Voting common stock (¶ *5:225*)	Sales to “nonexcluded” persons limited to one class voting common stock or preferred stock having voting rights equal to common (¶ *5:304.11*)
Specific disclosure requirements	Substantial disclosures req'd (offering circular must be cleared by SEC) (¶ *5:106.12 ff.*)	Resale restrictions, if applicable	Substantial disclosures req'd (except “accredited” investors) (¶ *5:182 ff.*)	Substantial disclosures req'd (offering circular must be cleared by SEC)	None	None	Substantial disclosures req'd (except “excluded” purchasers) (¶ *5:304.15*)
Resale restrictions	Yes—one year (¶ *5:106.26*)	Yes, *withexceptions* (¶ *5:130 ff.*)	Yes	No	No (but investment representation)	No (but investment representation)	No (but investment representation)
General solicitation and advertising permitted	No	No, *withexceptions* (¶ *5:121 ff.*)	No under 506(b) (¶ *5:173*); Yes under 506(c) (¶ *5:181*)	Yes	No	No	Yes
Notice of share issuance	“Miniregistration” req'd prior to offers or sales	File with SEC 15 days after 1st sale	File with SEC 15 days after 1st sale	“Mini-registration” req'd prior to offers or sales	File with Commr. 15 days after first sale in California (¶ *5:297*)	File with Commr. 10 days after receipt of consideration (¶ *5:249*)	File with Commr. upon initial solicitation, 10 days after last sale (¶ *5:304.25*)
Effect of nonfiling	Loss of exemption	Exemption available but may be disqualified	Exemption available but may be disqualified	Loss of exemption	No effect on exemption (¶ *5:253*)	Monetary fee penalty (¶ *5:253*)	Exemption lost for failure to file *first* notice

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

		from future use of Reg. D (¶ *5:137*)	from future use of Reg. D (¶ *5:137*)				

b. [5:81] **Intrastate offerings exemption (Rules 147 and 147A):** The 1933 Act exempts from its registration requirement securities offered and sold exclusively to residents of a single state by an issuer that is a resident of and doing business in the same state. There is *no limit on the size of the offering, or the number of offerees*. [SA § 3(a)(11) (15 USC § 77c(a)(11))]

The SEC adopted Rules 147 and 147A to provide a "safe harbor" for issuers seeking to utilize this exemption. As described below (¶ 5:83 ff.), Rules 147 and 147A are virtually identical, but SEC Rule 147A allows issuers to be incorporated or organized outside of the state in which the intrastate offering is conducted and permits *offers* to be made outside of the issuer's state of residence so long as all *sales* are made only to residents of the issuer's state of residence. [SA Rel. No. 33-10238 (2016)]

Of course, these are only "safe harbor" rules … so that even if an issue fails to qualify thereunder, the corporation may still seek to rely on the general language of SA § 3(a)(11), above. [See, e.g., *Busch v. Carpenter* (10th Cir. 1987) 827 F2d 653, 655, fn. 1]

➪ [5:81.1] ***Caveat—no preemption of state regulation:*** The intrastate offering exemption does not preempt concurrent state regulation. Thus, offerings conducted in reliance on the SA § 3(a)(11) exemption or SEC Rules 147 or 147A must still comply with all applicable state regulation. [SA § 18(a), (b)(4)(E) (15 USC § 77r(a), (b)(4)(E))]

(1) [5:82] **Issuer qualifications:** The issuer must meet two requirements: "residence" and "doing business" in the same state where the offering is made.

(a) Issuer's "residence"

1) [5:83] **Rule 147 requirements:** A corporate issuer is deemed to be a resident of the state or territory in which it is incorporated *and* has its "principal place of business." The "principal place of business" is the state or territory in which the officers primarily direct, control and coordinate the corporation's activities. [SEC Rule 147(c)(1)(i) (17 CFR § 230.147(c)(1)(i))]

Accordingly, SEC Rule 147 is *not* available to a corporation that is organized under the laws of one state but that has its principal place of business in another state (e.g., a Delaware corporation headquartered in California).

2) [5:83.1] **Rule 147A requirements:** The issuer is deemed resident of the state or territory in which it has its "principal place of business." As with SEC Rule 147 (¶ 5:83), the "principal place of business" is the state or territory in which the officers, partners or managers primarily direct, control and coordinate the issuer's activities. [SEC Rule 147A(c)(1) (17 CFR § 230.147A(c)(1))]

Thus, a Delaware corporation that has its principal place of business in California would be deemed resident in California.

(b) [5:84] **"Doing business":** Under both SEC Rule 147 and SEC Rule 147A, an issuer is deemed to be "doing business" within a state or territory if it satisfies at least *one* of the following four requirements:

- It derived at least 80% of its consolidated gross revenues from the operation of a business or of real property located in, or from the rendering of services within, such state or territory; *or*
- It had, at the end of its most recent semi-annual fiscal period prior to an initial offer of securities under the Rule, at least 80% of its assets (and those of its subsidiaries on a consolidated basis) located within such state or territory; *or*
- It intends to use and uses at least 80% of the net proceeds of the offering in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within, such state or territory; *or*
- A majority of its employees are based in such state or territory. [See SEC Rules 147(c)(2), 147A(c)(2) (17 CFR §§ 230.147(c)(2), 230.147A(c)(2))]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[5:85 - 5:88] ***Reserved.***

(2) [5:89] **Issuee qualifications:** Here again, the requirements under SEC Rule 147 differ from those under SEC Rule 147A:

• [5:89.1] **Rule 147** provides that offers *and* sales of securities may be made only to residents of the state or territory in which the issuer is resident (¶ 5:83 ff.) or who the issuer *reasonably believes*, at the time of the offer and sale, are residents of the state or territory in which the issuer is resident. [SEC Rule 147(d) (17 CFR § 230.147(d))]

• [5:89.2] **Rule 147A**, on the other hand, has *no* limitation on offers, only on *sales*: Securities *sales* may be made only to residents of the state or territory in which the issuer is resident (¶ 5:83 ff.) *or* who the issuer reasonably believes, at the time of the sale, are residents of the state or territory in which the issuer is resident. [SEC Rule 147A(d) (17 CFR § 230.147A(d))]

(a) [5:90] **"Residence":** Offerees and purchasers are deemed to "reside" in the state where they have their *principal* residence (domicile) at the time of *both the offer and sale* for offerings conducted under SEC Rule *147*, and at the time of *sale* for offerings conducted under Rule *147A*. [SEC Rules 147(d)(2), 147A(d)(2) (17 CFR §§ 230.147(d)(2), 230.147A(d)(2))]

1) [5:91] **Business entities:** An offeree/purchaser that is a partnership, corporation, trust or other form of business organization "resides" in the state where its "principal place of business" is located (*see ¶ 5:83 ff.*). Exception: If such an entity was formed for the specific purpose of acquiring securities under the intrastate offering exemption, it does not qualify as a local "resident" unless *all* of its beneficial owners also qualify as residents of the state. [SEC Rule 147(d)(1), (3) (17 CFR § 230.147(d)(1), (3)); SEC Rule 147A(d)(1), (3) (17 CFR § 230.147A(d)(1), (3))]

2) [5:91.1] **Trusts:** A trust that is not a separate legal entity (e.g., "Smith Family Trust") is deemed to "reside" in the state in which its trustee or trustees "reside." [SEC Rule 147(d)(1) (17 CFR § 230.147(d)(1)), Instruction to SEC Rule 147(d)(1); SEC Rule 147A(d)(1) (17 CFR § 230.147A(d)(1)), Instruction to SEC Rule 147A(d)(1)]

Where the trust has two trustees and only one resides in the state where the offering is made, the issuer may nonetheless offer and sell securities to the trust in a *SEC Rule 147* offering. [Securities Act Rules Compliance & Disclosure Interpretations § 541.03]

a) [5:91.2] **Comment:** It is not clear why Securities Act Rules Compliance & Disclosure Interpretations § 541.03 is limited to SEC Rule 147 offerings. It would appear that *sales* should likewise be permitted to a trust in a *SEC Rule 147A* offering where one trustee resides in the state in which the offering is made.

(b) [5:92] **Written representations re "residence":** Under both SEC Rule 147 and SEC Rule 147A, whether an issuer reasonably believes that the offerees and purchasers (Rule 147) or purchasers (Rule 147A) reside in the state or territory in which the issuer is resident depends on all of the facts and circumstances. Customary practice is to obtain written representations from offerees/purchasers as to their state or territory of residence. But obtaining such written representations will not, without more, suffice to establish a reasonable belief that such offerees/purchasers are in-state residents. [SEC Rule 147(d) (17 CFR § 230.147(d)), Instruction to Paragraph (d); SEC Rule 147A(d) (17 CFR § 230.147A(d)), Instruction to Paragraph (d)]

[5:93] ***Reserved.***

(3) [5:94] **Integration of offerings—"safe harbors":** *See discussion at* ¶ 5:114 ff.

[5:95 - 5:96] ***Reserved.***

(4) [5:97] **No restriction on use of interstate commerce facilities:** The intrastate offering exemption is based primarily on the residence of the parties, rather than the means used to make the offering. Thus, the exemption is not lost because the mails, telephones or other instrumentalities of interstate commerce are used to offer, sell or deliver the securities. Even general newspaper advertising is permissible, as long as the ads state that the offer to sell is being made only to residents of the state.

(a) [5:97.1] **Rule 147A—general solicitation expressly permitted:** As stated above (¶ 5:81, 5:89.2), SEC Rule 147A does not limit *offers* to in-state residents. Additionally, issuers are expressly permitted to engage in general solicitation

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

and general advertising of their offerings by using any form of mass media, including unrestricted, publicly-available Internet websites, so long as all securities *sales* are made only to residents of the state or territory in which the issuer is resident. [SEC Rule 147A(b) (17 CFR § 230.147A(b)); see SA Rel. No. 33-10238, p. 18 (2016)]

(5) [5:98] **Resale restrictions:** Resales of securities purchased under SEC Rule 147 or 147A may be made only to persons *resident within the state or territory in which the issuer was resident* for a period of *six* months from the date of the sale of the security to the *seller*. [SEC Rules 147(e), 147A(e) (17 CFR §§ 230.147(e), 230.147A(e))]

[5:99] ***Reserved.***

(a) [5:100] **Precautions against interstate sales:** To prevent interstate sales of securities sold under SEC Rule 147 or 147A, the issuer is required to take the following precautions:

• [5:101] A restrictive *legend* must be placed on the certificate or other document evidencing the security, stating that "Offers and sales of these securities were made under an exemption from registration and have not been registered under the Securities Act of 1933. For a period of six months from the date of the sale by the issuer of these securities, any resale of the securities (or the underlying securities in the case of convertible securities) shall be made only to persons resident within the state or territory of [identify the name of the state or territory in which the issuer was resident at the time of the sale of the securities by the issuer]." [SEC Rule 147(f)(1)(i), (2) (17 CFR § 230.147(f)(1)(i)); SEC Rule 147A(f)(1)(i), (2) (17 CFR § 230.147A(f)(1)(i), (2))]

• [5:102] *Stop-transfer instructions* must be given to the issuer's transfer agent (if any), or if the issuer handles securities transfers, the issuer must make a notation on its records not to transfer the securities on the issuer's books, or to issue new documents evidencing the securities, within the six-month period, without satisfactory documentation showing the transferee is a resident of the same state. [SEC Rule 147(f)(1)(ii) (17 CFR § 230.147(f)(1)(ii)); SEC Rule 147A(f)(1)(ii) (17 CFR § 230.147A(f)(1)(ii))]

• [5:102.1] A *written representation* must be obtained from each purchaser as to their residence. [SEC Rule 147(f)(1)(iii) (17 CFR § 230.147(f)(1)(iii)); SEC Rule 147A(f)(1)(iii) (17 CFR § 230.147A(f)(1)(iii))]

• [5:103] The issuer must *prominently disclose,* at the time of any *offer or sale*, to each *offeree* in the manner in which the offer is communicated, and to each *purchaser* in writing a reasonable period of time before the date of sale, the following: "Sales will be made only to residents of [identify the name of the state or territory in which the issuer was resident at the time of the sale of the securities by the issuer]. Offers and sales of these securities are made under an exemption from registration and have not been registered under the Securities Act of 1933. For a period of six months from the date of the sale by the issuer of the securities, any resale of the securities (or the underlying securities in the case of convertible securities) shall be made only to persons resident within the state or territory of [identify the name of the state or territory in which the issuer was resident at the time of the sale of the securities by the issuer]." [SEC Rule 147(f)(3) (17 CFR § 230.147(f)(3)); SEC Rule 147A(f)(3) (17 CFR § 230.147A(f)(3))]

(b) [5:104] **Compare—Rule 144 resale limitations inapplicable to public offerings:** Unlike shares issued under SEC Rule 506 (or, generally, under SEC Rule 504) of the Regulation D exemption (*discussed at ¶ 5:107 ff.*), securities issued under SEC Rule 147 or SEC Rule 147A are *not* explicitly labeled "restricted securities." However, they may still be considered such under SEC Rule 144 if they are issued in a *nonpublic* offering. Only *public* intrastate offerings fall clearly outside the scope of Rule 144 and its resale provisions. (*See ¶ 5:125 ff.*)

(6) [5:105] **No report to SEC required:** Also, unlike issuances under the Regulation D exemptions (¶ 5:107 ff.), securities issued under the intrastate offerings exemption need *not* be reported to the SEC.

c. [5:106] **"Crowdfunding" ($5 million) exemption (SA § 4(a)(6); Regulation Crowdfunding Rule 100 et seq.):** The 1933 Act exempts from its registration requirements certain "crowdfunding" (or "crowdfunded") offerings made via the Internet in compliance with SEC rules. [See SA §§ 4(a)(6)(A) (15 USC § 77d(a)(6)(A)), 4A (15 USC § 77d-1)]

In the United States, crowdfunding initially did not involve the offer of investments in business enterprises but, rather, was used to provide funding for social causes. With the SEC's adoption of rules effective May 16, 2016, "crowdfunding" generally refers to the offer and sale of securities by start-up and emerging companies over the Internet to large numbers of investors who each invest relatively small amounts of money. [See Reg. Crowdfunding Rule 100 et seq. (17 CFR § 227.100 et seq.); SEC Rel. No. 33-9974 (2015)]

(1) [5:106.1] **$5 million maximum:** The aggregate amount of securities sold to all investors by the issuer (*see ¶ 5:106.2*) under the crowdfunding exemption may not exceed $5 million in any 12-month period. [SA § 4(a)(6)(B) (15 USC § 77d(a)(6)(B)); Reg. Crowdfunding Rule 100(a)(1) (17 CFR § 227.100(a)(1))]

(a) [5:106.2] **Aggregated with crowdfunding offerings by commonly-controlled entities:** For purposes of the $5 million cap, the "issuer" includes *all entities controlled by, or under common control with, the issuer and any of its predecessors*. "Control" means the power to direct the management and policies of the entity through the ownership of voting securities, by contract, or otherwise. Thus, *crowdfunded* securities sold by a *predecessor or other entity owned by the same person or persons who own the issuer* would be included in the $5 million limit. [Reg. Crowdfunding Rule 100(c) (17 CFR § 227.100(c)) & Instruction to paragraph (c)]

(b) [5:106.3] **Integration with other exempt offerings:** *See discussion at* ¶ 5:114 ff.

(2) [5:106.4] **Issuer requirements:** Not all companies are eligible to raise money through crowdfunding. Companies that are *not* eligible include:

• Non-U.S. companies;

• SEA reporting companies;

• Certain investment companies;

• Companies that are disqualified from using crowdfunding (*see ¶ 5:106.21 ff.*);

• Companies that failed to comply with the annual reporting requirements under crowdfunding during the two years immediately preceding the filing of an offering statement (but the company may use crowdfunding once it complies with the reporting requirements); and

• So-called "blank check" companies that have no specific business or whose business plan is to engage in a merger or acquisition with an unidentified company. [SA § 4A(f) (15 USC § 77d-1(f)); Reg. Crowdfunding Rule 100(b) (17 CFR § 227.100(b)) & Instruction to paragraph (b)(5)]

(3) [5:106.5] **Limit on non-accredited investor's total crowdfunding purchases:** Individual investments made by a non-accredited investor (¶ 5:174 ff.) in *all* crowdfunding issuers (not just any one crowdfunding issuer) within any 12-month period are limited:

• Where the investor's annual income *or* net worth is *less than $107,000*, all crowdfunding purchases may not exceed the *greater* of (i) *$2,200* or (ii) *5%* of the *greater* of the investor's annual income *or* net worth; and

• Where both the investor's annual income and net worth are *each* $107,000 or more, all crowdfunding purchases may not exceed 10% of the *greater* of the investor's annual income or net worth, and capped at $107,000. [SA § 4(a)(6)(B) (15 USC § 77d(a)(6)(B)); Reg. Crowdfunding Rule 100(a)(2) (17 CFR § 227.100(a)(2))]

(a) [5:106.6] **"Annual income" and "net worth":** "Annual income" and "net worth" have the same meanings as in Reg. D (*see ¶ 5:174.5*). [SA § 4A(h)(2) (15 USC § 77d-1(h)(2)); Reg. Crowdfunding Rule 100(a)(2) (17 CFR § 227.100(a)(2)), Instruction 1 to paragraph (a)(2)]

➪ [5:106.7] ***PRACTICE POINTER:*** Examples of the method of calculating "net worth" are found in Updated Investor Bulletin: Crowdfunding for Investors (2017), available on the SEC website (*www.sec.gov*).

(b) [5:106.8] **Spouses counted as one:** For the purpose of determining their investment limit, spouses may combine their annual income and net worth. However, the spouses' aggregate investment may not exceed the limit that would apply to an *individual* investor at that income or net worth level. [Reg. Crowdfunding Rule 100(a)(2) (17 CFR § 227.100(a)(2)), Instruction 2 to paragraph (a)(2)]

(c) [5:106.9] **Non-natural persons:** Non-natural persons are subject to the investment limits. But instead of calculating limits based on annual income and net worth, a non-natural person should calculate the limits based on its revenue and net assets (as of its most recent fiscal year end). [Regulation Crowdfunding Compliance & Disclosure Interpretations, Question 100.2]

(d) [5:106.10] **Reliance upon funding intermediary:** The issuer may rely upon a funding intermediary (*see ¶ 5:106.27*) to ensure that an investor's securities purchase does not exceed the investor's limit. (But reliance is not justified if the issuer has *actual knowledge* that the investor has exceeded the limit.) [Reg. Crowdfunding Rule 100(a)(2) (17 CFR § 227.100(a)(2)), Instruction 3 to paragraph (a)(2)]

(4) [5:106.11] **Dollar amounts indexed to inflation:** At least once every five years, the SEC must adjust all dollar amounts in the crowdfunding provisions to reflect any change in the Consumer Price Index published by the Bureau of Labor Statistics. [SA § 4A(h)(1) (15 USC § 77d-1(h)(1))]

The most recent inflationary adjustments were made on March 31, 2017. [See SEC Rel. No. 33-10332 (2017)]

(5) [5:106.12] **Disclosure requirements:** A company that conducts a crowdfunding offering must file certain information with the SEC on Form C, which requires most of the disclosures to be presented in a specified format. The company must also provide this information to its investors and the funding intermediary facilitating the crowdfunding offering. [Reg. Crowdfunding Rules 203(a) (17 CFR § 227.203(a)), 900 (17 CFR § 239.900)]

A company must file the disclosures before offering the securities, but may provide "testing-the-waters" materials to potential investors in accordance with Rule 206 (17 CFR § 227.206; ¶ 5:106.16a ff.). [Reg. Crowdfunding Rules 203(a) (17 CFR § 227.203(a))]

The company is required to disclose:

• Information about its officers, directors and owners of 20% or more of the company's outstanding voting securities;

• A description of the company's business and intended use of proceeds from the offering;

• A discussion of "risk factors" in the investment;

• The price to the public of the securities or the method for determining the price, the target offering amount, the deadline to reach the target offering amount, and whether the issuer will accept investments in excess of the target offering amount;

• A statement that (i) the investor may cancel a decision to invest until 48 hours before the offering deadline (per Reg. Crowdfunding Rule 304(a)) and, (ii) where a material change is made to the offering, the purchase will be canceled and the investor's money will be returned unless the investor reconfirms the purchase (per Reg. Crowdfunding Rule 304(c));

• A description of the securities being offered, including voting rights and transfer restrictions, and of any other securities of the issuer;

• Information regarding the funding intermediary (*¶ 5:106.27*), including its compensation in the offering;

• Any exempt offerings conducted within the past three years;

• Certain related party transactions between the issuer and any officers, directors, 20%-or-more shareholders, promoters or their family members;

• A discussion of the issuer's financial condition, which must cover each period for which financial statements are provided (but start-ups "should focus on financial milestones and operational, liquidity and other challenges"), as well as a discussion of expected changes or trends;

• Financial statements (*see ¶ 5:106.13*);

• Disclosure of any pre-May 16, 2016 disqualification events (*see ¶ 5:106.23*), unless the company did not know and through the exercise of reasonable diligence could not have known of the events;

• Where on the company's website the investors will be able to find the company's annual report and the date by which the report will be available;

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Whether the company or any of its predecessors failed to comply with ongoing reporting requirements required by the crowdfunding rules (*see ¶ 5:106.16 ff.*); and

• "Any material information necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." [SA § 4A(b)(1), (4)(15 USC § 77d-1(b)(1), (4)); Reg. Crowdfunding Rule 201 (17 CFR § 227.201)]

(a) [5:106.13] **Financial statements:** In offerings of *$107,000 or less*, the financial statements must be accompanied by corresponding federal tax information, but need only be *certified by the company's principal executive officer*. [Reg. Crowdfunding Rule 201(t)(1) (17 CFR § 227.201(t)(1))]

In offerings of *more than $107,000 up to $535,000*, the financial statements must be *reviewedby an independent public accountant*. [Reg. Crowdfunding Rule 201(t)(2) (17 CFR § 227.201(t)(2))]

In offerings *over $535,000*, the financial statements must be *audited* by an independent public accountant *unless* the company is a first-time crowdfunding issuer, in which event the financial statements need only be *reviewed* by an independent public accountant. [Reg. Crowdfunding Rule 201(t)(3) (17 CFR § 227.201(t)(3)); *see*¶ 5:305.24 ff. (California exemption for small offerings)]

1) [5:106.14] **Aggregation of prior offerings:** For the purpose of determining the type of financial statements that must be provided (*¶ 5:106.13*), the amount of all crowdfunded securities sold within the preceding 12 months must be included in the amount of the offering. [Reg. Crowdfunding Rule 201(t) (17 CFR § 227.201(t)), Instruction 1 to paragraph (t)]

2) [5:106.15] **Contents; GAAP required:** All financial statements must be prepared in accordance with generally accepted accounting principles (GAAP) and must include a balance sheet, comprehensive income and cash flow statements, statements of changes in "stockholders' equity," and accompanying notes. Financial statements must cover the two most recently completed fiscal years (or if shorter, the period since inception). [Reg. Crowdfunding Rule 201(t) (17 CFR § 227.201(t)), Instruction 3 to paragraph (t); see Regulation Crowdfunding Compliance & Disclosure Interpretations, Question 201.01]

(b) [5:106.16] **Amendments and updates:** An issuer must amend its Form C offering statement during the offering period to reflect material changes that occur during the offering period. The issuer must also provide updates on the issuer's progress towards reaching the target offering amount. [Reg. Crowdfunding Rule 203(a)(2) (17 CFR § 227.203(a)(2))]

(c) [5:106.16a] **"Testing the waters" materials (Rule 206):** Before incurring the expense of preparing and filing a Form C offering statement (¶ 5:106.12), Rule 206 allows issuers to communicate orally or in writing with potential investors to "test the waters," i.e., to "determine whether there is any interest in a contemplated securities offering." [Rule 206(a) (17 CFR § 227.206(a)); SEC Rel. Nos. 33-10884 & 34-90300, at 95-97 (2020)]

Rule 206 is largely based on the "testing-the-waters" rule of Regulation A (Rule 255; ¶ 5:191.3). [SEC Rel. Nos. 33-10884 & 34-90300, at 97 (2020)]

1) [5:106.16b] **Before filing offering statement only:** Unlike Rule 255 (¶ 5:191.3), Rule 206 does not allow issuers to use testing-the-waters materials both before and after filing an offering statement. Rather, Rule 206 only permits issuers to use testing-the-waters materials before filing a Form C offering statement (¶ 5:106.12). [Rule 206(a) (17 CFR § 227.206(a)); SEC Rel. Nos. 33-10884 & 34-90300, at 98 (2020)]

2) [5:106.16c] **Must include legends:** Rule 206 requires issuers to include legends in their testing-the-waters materials that state the following (Rule 206(b) (17 CFR § 227.206(b))):

• No money or other consideration is being solicited, and if money is sent in response, it will not be accepted. [Rule 206(b)(1) (17 CFR § 227.206(b)(1))]

• No offer to buy the securities can be accepted; no part of the purchase price can be received until the offering statement is filed; and the purchase price can only be received through an intermediary's platform. [Rule 206(b)(2) (17 CFR § 227.206(b)(2))]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• A person's indication of interest involves no obligation or commitment of any kind. [Rule 206(b)(3) (17 CFR § 227.206(b)(3))]

(6) [5:106.17] **Annual report:** Companies relying upon Regulation Crowdfunding are also required to file an annual report with the SEC and post the annual report on their website within 120 days after the end of their fiscal year. [SA § 4A(b)(1), (4) (15 USC § 77d-1(b)(1), (4)); Reg. Crowdfunding Rules 202(a) (17 CFR § 227.202(a)), 203(b)(1) (17 CFR § 227.203(b)(1))]

(a) [5:106.18] **Contents:** The report must contain information about the company, its business, officers, directors, 20%-or-more shareholders, related transactions and other matters. The annual report must also contain financial statements certified by the company's principal executive officer (unless financial statements reviewed or audited by an independent public auditor are available, in which case those statements must be used). [Reg. Crowdfunding Rules 202(a) (17 CFR § 227.202(a)), 203(b)(1) (17 CFR § 227.203(b)(1))]

(b) [5:106.19] **Amendments:** If there is a material change to the annual report, the company must file an amendment with the SEC as soon as practicable. [Reg. Crowdfunding Rule 203(b)(2) (17 CFR § 227.203(b)(2))]

(c) [5:106.20] **When report requirement terminates:** The company must continue to file annual reports with the SEC and post the annual reports on its website until one of the following occurs:

• The company is required to file reports under SEA § 13(a) or 15(d);

• The company has filed, since its most recent crowdfunding sale of securities, at least one annual report and has fewer than 300 shareholders of record;

• The company has filed, since its most recent crowdfunding sale of securities, annual reports for at least the three most recent years and has total assets that do not exceed $10 million;

• All of the securities issued in the crowdfunding offering are purchased by another party or by the company; or

• The company liquidates and dissolves. [Reg. Crowdfunding Rule 202(b) (17 CFR § 227.202(b))]

When the issuer no longer has an obligation to file annual reports, it must file a report to that effect with the SEC and advise its investors accordingly. [Reg. Crowdfunding Rule 203(b)(3) (17 CFR § 227.203(b)(3))]

(7) [5:106.21] **"Bad actor" disqualification:** The crowdfunding exemption is not available if "covered persons" connected to the issuer or the offering (*¶ 5:106.22*) committed disqualifying acts (*¶ 5:106.23*) that occurred *afterMay 15, 2016*. The "bad actor" provisions of Regulation Crowdfunding are based on the "bad actor" provisions set forth in Rule 262 of Regulation A and in Rule 506 of Regulation D. Disqualification applies unless the issuer establishes that it did not know and, in the exercise of reasonable care could not have known, of the disqualifying act. [Reg. Crowdfunding Rule 503(a), (b)(1), (4) (17 CFR § 227.503(a), (b)(1), (4))]

(a) [5:106.22] **"Covered persons":** "Covered persons" include the issuer, any predecessor or affiliated issuer, any director or officer of the issuer, any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, any promoter, and any person that has been or will be paid compensation for soliciting purchasers. [Reg. Crowdfunding Rule 503(a), (c) (17 CFR § 227.503(a), (c))]

(b) [5:106.23] **Disqualifying acts:** The post-May 15, 2016 disqualifying acts include:

1) [5:106.23a] **Felony and misdemeanor convictions:** Any felony or misdemeanor conviction within 10 years before the filing of the offering statement or such sale (or five years in the case of issuers, their predecessors and affiliated issuers) that (i) was in connection with the purchase or sale of a security, (ii) involved the making of a false filing with the SEC, or (iii) arose out of the conduct of the business of an underwriter, broker-dealer, municipal securities dealer, investment adviser, funding portal or paid solicitor. [Reg. Crowdfunding Rule 503(a)(1) (17 CFR § 227.503(a)(1))]

2) [5:106.23b] **Injunctions or court orders:** An injunction and court order within five years before the filing or sale that, at the time of filing or sale, restrains or enjoins the person from engaging in, or continuing to engage in, any conduct or practice in connection with the purchase or sale of securities or other related misconduct. [Reg. Crowdfunding Rule 503(a)(2) (17 CFR § 227.503(a)(2))]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

3) [5:106.23c] **Final orders from government regulators:** A final order of a state and federal regulator that (i) at the time of filing or sale, bars the person from associating with an entity regulated by the state or federal regulator, engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or (ii) is based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct and is entered within 10 years before the filing or sale. [Reg. Crowdfunding Rule 503(a)(3) (17 CFR § 227.503(a)(3))]

4) [5:106.23d] **SEC suspension, revocation, limitation or ban:** An SEC order that, at the time of filing or sale, (i) suspends or revokes the person's registration as a broker, dealer, municipal securities dealer, investment adviser or funding portal, (ii) limits the person's activities, functions or operations, or (iii) bars the person from associating with any entity or participating in the offering of any penny stock. [Reg. Crowdfunding Rule 503(a)(4) (17 CFR § 227.503(a)(4))]

5) [5:106.23e] **SEC cease-and-desist orders:** An SEC cease-and-desist order entered within five years before the filing or sale that, at the time of the filing or sale, orders the person to cease and desist from committing or causing a violation or future violation of securities-based anti-fraud provisions of the federal securities laws. [Reg. Crowdfunding Rule 503(a)(5) (17 CFR § 227.503(a)(5))]

6) [5:106.23f] **Suspension or expulsion from national securities exchange or association:** Being suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a national securities association for conduct inconsistent with just and equitable principles of trade. [Reg. Crowdfunding Rule 503(a)(6) (17 CFR § 227.503(a)(6))]

7) [5:106.23g] **Statement subject to refusal order, stop order or suspension order:** The person filed (as a registrant or issuer), or was (or was named) the underwriter in, any registration statement or Regulation A offering statement that (i) was the subject of a refusal order, stop order, or order suspending the Regulation A exemption within five years before filing the information required by SA § 4A(b) (15 USC § 77d-1(b)) or such sale, or (ii) at the time of such filing or sale, was the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued. [Reg. Crowdfunding Rule 503(a)(7) (17 CFR § 227.503(a)(7))]

8) [5:106.23h] **Mail fraud:** The person (i) is subject to a United States Postal Service false representation order entered within five years before filing the information required by SA § 4A(b) (15 USC § 77d-1(b)) or such sale, or (ii) at the time of such filing or sale, is subject to a temporary restraining order or preliminary injunction based on allegations by the United States Postal Service that they were involved in a scheme or device to obtain money or property through the mail by means of false representations. [Reg. Crowdfunding Rule 503(a)(8) (17 CFR § 227.503(a)(8))]

(c) [5:106.24] **Waiver by SEC:** Waivers of the bad actor disqualifying provisions are available from the SEC in certain circumstances. [Reg. Crowdfunding Rule 503(b) (17 CFR § 227.503(b))]

(8) [5:106.25] **No advertising:** The issuer may not advertise the terms of the offering, except for oral or written communications directing investors to the funding intermediary and containing the following information:

• A statement that the issuer is conducting a crowdfunding offering pursuant to SA § 4(a)(6), the name of the intermediary and a link directing the potential investor to the intermediary's platform;

• The terms of the offering (amount, nature and price of the securities and the closing date of the offering period); and

• Factual information about the legal identity and business location of the issuer, limited to the issuer's name, address, phone number and website, as well as the email address of a representative of the issuer and a brief description of the issuer's business. [SA § 4A(b)(2) (15 USC § 77d-1(b)(2)); Reg. Crowdfunding Rule 204(a), (b) (17 CFR § 227.204(a), (b), 17 CFR § 227.204(a), (b)) & Instruction; see Regulation Crowdfunding Compliance & Disclosure Interpretations, Questions 204.01, 204.03 & 204.04]

The notices may be in video format so long as the videos comply with these requirements. [Regulation Crowdfunding Compliance & Disclosure Interpretations, Question 204.02]

(9) [5:106.26] **Transfer restrictions:** Securities purchased under the crowdfunding exemption may not be transferred for a period of *one year* except (a) to the issuer, an "accredited investor" (as defined in Reg. D, ¶ 5:174 ff.) or a family member

or family trust, (b) in connection with death or divorce, or (c) as part of a registered offering. [SA § 4A(e) (15 USC § 77d-1(e)); Reg. Crowdfunding Rule 501 (17 CFR § 227.501)]

(10) [5:106.27] **Licensed funding intermediary required:** The offering must be conducted exclusively through the platform of an intermediary that is *registered* with the SEC as a *broker-dealer* or as a "*funding portal*." A "funding portal" is an intermediary that does *not* (a) offer investment advice or recommendations, (b) solicit purchases or sales of the securities displayed on its website or portal, (c) compensate employees, agents or others for soliciting purchasers or selling securities displayed on its website or portal, or (d) hold, manage or otherwise handle investor funds or securities. The issuer may *not* conduct a crowdfunding offering or make concurrent crowdfunding offerings using more than one intermediary. [SA §§ 4(a)(6)(C), 4A(a)(1), (2)(15 USC §§ 77d(a)(6)(C), 77d-1(a)(1), (2)); SEA § 3(a)(80) (15 USC § 78c(a)(80)) (second of two enacted as "(80)"); Reg. Crowdfunding Rules 100(a)(3) (17 CFR § 227.100(a)(3)) & Instruction to paragraph (a)(3), 402(a) (17 CFR § 227.402(a))]

(a) [5:106.28] **Disclosure and "due diligence" requirements:** The broker-dealer or funding portal must undertake various obligations with respect to the offering, including:

- Providing various "investor education materials" that describe, among other things, the process for securities purchases, monetary limitations on investments, and the risks of crowdfunded securities;

- Taking steps to ensure that investors understand the risk of loss and illiquidity of their investments, and that investors comply with the monetary limitations on investment (*¶ 5:106.5*);

- Performing background checks on the issuer's officers, directors and persons holding 20% or more of the issuer's outstanding equity, and reducing the risk of fraud by having a reasonable basis to believe that the issuer is complying with the crowdfunding rules;

- Making available to the SEC and potential investors, at least 21 days prior to the offering, information the issuer is required to provide (*see ¶ 5:106.12 ff.*);

- Providing communication channels on its platform by which persons can communicate with each other and with issuer representatives regarding offerings;

- Tracking and confirming investment commitments and sales; and

- Ensuring that offering proceeds are provided to the issuer only when the aggregate capital raised from the offering meets the target amount. [SA § 4A(a)(3)-(7) (15 USC § 77d-1(a)(3)-(7)); Reg. Crowdfunding Rules 301, 302(b), 303 (17 CFR §§ 227.301, 227.302(b), 227.303)]

(b) [5:106.29] **Limitation on ownership interest in issuer:** Neither the funding intermediary, nor any of its directors or officers, may have a financial interest in the issuer. However, the intermediary may receive, as compensation for services provided to the issuer in connection with the offering, securities of the same type as are sold in the offering. [Reg. Crowdfunding Rule 300(b) (17 CFR § 227.300(b))]

➪ [5:106.30] ***PRACTICE POINTERS:*** Funding intermediaries typically do not guarantee to "fill the offering," which can leave the issuer with only a portion of the needed capital and the need to seek alternative financing sources.

When the Regulation Crowdfunding rules were proposed, the SEC estimated that the fees charged by funding intermediaries, expressed as a percentage of the offering amount, would be 5% to 15% for offerings of $100,000 or less, 5% to 10% for offerings between $100,000 and $500,000, and 5% to 7.5% for offerings above $500,000. These estimates have thus far proven accurate. [See SA Rel. No. 33-9974 (2015), p. 403]

(11) [5:106.31] **Effect of failure to strictly comply with crowdfunding rules—"insignificant deviations":** Failure to comply with all of the terms of the crowdfunding rules will not result in loss of the exemption if the issuer shows:

- The failure was "*insignificant*" with respect to the offering as a whole;

- The issuer made a *good faith and reasonable attempt* to fully comply; and

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- The issuer did not know of the failure where the failure was on the part of the *intermediary*, or the failure by the intermediary occurred *solely in other issuers' offerings*. [Reg. Crowdfunding Rules 100(a)(4) (17 CFR § 227.100(a)(4)) (emphasis added)]

(12) [5:106.32] **Preemption of state crowdfunding provisions:** Some 35 states have enacted provisions to facilitate equity crowdfunding. California is not among these states, although California has an exemption for Internet offerings (but not sales—*see ¶ 5:212.5*). [North American Securities Administrators Association, Intrastate Crowdfunding Directory (available at *www.nasaa.org*)]

Now that the SEC has adopted Regulation Crowdfunding, state provisions (other than with respect to facilitating the distribution of crowdfunding securities through funding portals or other intermediaries) may fall by the wayside because the 1934 Act preempts the states from regulating the registration or qualification of securities issued in accordance with the crowdfunding exemption. [SA § 18(a)(1)(A), (b)(4)(C) (15 USC § 77r(a)(1)(A), (b)(4)(C))]

Nevertheless, states retain their authority to investigate and bring enforcement actions in connection with crowdfunding offerings and to impose filing fees for required notices of offers and sales of securities. However, only the state of the issuer's *principal place of business*, or *any* state in which *purchasers of 50% or more of the aggregate amount of the securities sold in the crowdfunding offering reside*, may impose filing fees. [SA § 18(c)(1), (2)(F) (15 USC § 77r(c)(1), (2)(F))]

(13) [5:106.33] **1934 Act registration ordinarily not required:** Ordinarily, corporations must register with the SEC if they have more than 2,000 record shareholders (or more than 500 record shareholders who are not accredited investors) and total assets exceeding $10 million. The corporation then becomes subject to the reporting requirements, proxy solicitation rules, short-swing profit rules, and other provisions of the 1934 Act. [See SEA § 12(g) (15 USC § 78*l*(g))]

For purposes of the § 12(g) registration requirement, the holders of securities purchased in a crowdfunding transaction are not included in the 2,000/500 shareholder count if the crowdfunding issuer (a) is current in its annual crowdfunding reporting obligations, (b) retains the services of a registered transfer agent, *and* (c) has less than $25 million in assets. [Rule 12g-6, 17 CFR § 240.12g-6]

(14) [5:106.34] **Liability for material misstatements or omissions:** Liability may lie if any written or oral communication made in connection with a crowdfunding offering contains any untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. [SA § 4A(c)(2)(A) (15 USC § 77d-1(c)(2)(A))]

(a) [5:106.35] **Scope of recovery:** A purchaser who still owns the securities may rescind the purchase and recover the full amount paid for the securities, together with interest, less any amounts received on the securities. A purchaser who no longer owns the securities may recover the amount lost on the investment. [SA § 4A(c)(1)(A) (15 USC § 77d-1(c)(1)(A))]

(b) [5:106.36] **Who may be liable:** Suit may be brought against:

- The issuer;
- The issuer's directors, principal executive officer or officers, principal financial officer, controller or principal accounting officer, and any person occupying a similar status or performing a similar function; and
- Any person who offered or sold the securities. [SA § 4A(c)(2), (3) (15 USC § 77d-1(c)(2), (3))]

(c) Defenses

1) [5:106.37] **Defendant's lack of knowledge:** Proof that defendant did not know, and in the exercise of reasonable diligence could not have known, of the untruth or omission is a valid defense. But defendant bears the burden of proof. [SA § 4A(c)(2)(B) (15 USC § 77d-1(c)(2)(B))]

2) [5:106.38] **Plaintiff's knowledge:** It is also a valid defense to show that *plaintiff knew* of the untruth or omission at the time of purchase (i.e., no reliance on the false or omitted statement). But again, defendant bears the burden of proof. [SA § 4A(c)(2)(A) (15 USC § 77d-1(c)(2)(A))]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

3) [5:106.39] **No causation between misstatement and loss:** Defendant is not liable for any portion of the security's diminution in value caused by something other than defendant's misrepresentation or material omission. Here again, defendant bears the burden of proof. [SA § 4A(c)(1)(B), § 12(b) (15 USC §§ 77d-1(c)(1)(B), 77*l*(b))]

(d) [5:106.40] **One-year/three-year statute of limitations:** Plaintiff must bring the action within one year after plaintiff *discovered*, or through the exercise of "reasonable diligence" *should have discovered,* the false statement or omission, but in any event *no later than three years after the sale*. [SA §§ 4A(c)(1)(B), 13 (15 USC §§ 77d-1(c)(1)(B), 77m); *see* ¶ *5:72 ff.*]

(e) [5:106.41] **Liability subject to SA §§ 12 and 13:** Liability for misstatements or omissions in crowdfunding offerings is expressly made subject to SA §§ 12(b) and 13) (¶ *5:106.39 ff.*), as if the liability were created under SA § 12(a)(2) (¶ *5:65 ff.*). Thus, cases decided under these sections may be relevant in an action arising from a crowdfunding offering. [SA § 4(c)(1)(B) (15 USC § 77d(c)(1)(B))]

d. [5:107] **Reg. D, Rule 504 ($10 million) exemption:** The 1933 Act authorizes the SEC to exempt offerings of up to $5 million from registration if it finds that enforcement of the securities laws with respect to such offerings "is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." The SEC initially adopted SEC Rule 504 pursuant to this authority. [SA § 3(b)(1) (15 USC § 77c(b)(1))]

The SEC has since raised Rule 504's offering limit to $10 million pursuant its general exemptive authority under SA § 28 (15 USC § 77z-3). [SEC Rule 504(b)(2) (17 CFR § 230.504(b)(2)); SEC Rel. Nos. 33-10884 & 34-90300 (2020)]

[5:108] SEC Rule 504 allows an issuer to sell, without registration, *up to $10 million of securities in any 12-month period*, to any number of purchasers, with no requirement that the purchasers be furnished any specific information. With several important exceptions, securities issued under Rule 504 have the same resale restrictions, and prohibitions on general solicitation and public advertising, as securities issued under SEC Rule 506.

[5:109] SEC Rule 504 is designed to be the "workhorse" exemption, covering capitalization of small businesses where the "intrastate offering" exemption is unavailable. Most small, closely-held businesses do not have to raise more than $10,000,000 upon formation or in any 12-month period thereafter.

➪ [5:109.1] ***Caveat—no preemption of state regulation:*** The SEC Rule 504 exemption was adopted by the SEC under SA § 3(b)(1) and hence does *not* preempt concurrent state regulation. Thus, offerings conducted in reliance on Rule 504 must still comply with all applicable state requirements. [SA § 18(a), (b)(4) (15 USC § 77r(a), (b)(4)); *see* ¶ *5:18.6*]

(1) [5:110] **Issuer qualification:** Any corporation may utilize the SEC Rule 504 exemption *except*:

- Companies subject to the 1934 Act reporting requirements;
- Companies subject to the Investment Company Act; or
- "Blank check" or "blind pool" companies (i.e., development stage ventures with no specific business plan or purpose other than to engage in mergers or acquisitions with other unidentified entities). [SEC Rule 504(a) (17 CFR § 230.504(a))]

(a) [5:110.1] **"Bad actor" disqualification:** The corporation may be disqualified from relying on SEC Rule 504 if certain persons connected to the corporation or the offering (e.g., directors, executive officers, promoters, 20%-or-more shareholders) were convicted of securities- or fraud-related crimes or were the subject of adverse regulatory or court orders. Disqualification will not occur, however, if the corporation shows it did not know, and in the exercise of reasonable care could not have known, of the conviction or order. Nor will pre-January 20, 2017 convictions or orders disqualify the corporation from using Rule 504 so long as they are disclosed to investors. [SEC Rule 504(b)(3) (17 CFR § 230.504(b)(3)); SEC Rel. No. 33-10238, pp. 71-82 (2016); see SEC Rule 506(d), (e) (17 CFR § 230.506(d), (e))]

(2) [5:111] **Size of offering:** There may be one or more issuances during any 12-month period, provided the *aggregate* amount raised does not exceed $10 million (i.e., there can be numerous small issues of shares, if necessary).

In determining the *aggregate* offering price, the following standards apply: (a) Payments made in foreign currencies are translated into U.S. dollars at their current exchange rates; and (b) values placed on *noncash* consideration must be *reasonable when made* (i.e., promoters cannot undervalue property contributions in order to fall below the aggregate price ceiling). [SEC Rule 501(c) (17 CFR § 230.501(c))]

(a) [5:111.1] **"Aggregated" offering price:** In determining the dollar ceilings of a SEC Rule 504 offering, the amounts of any other securities sold within 12 months before the start of and during the offering in reliance on any exemption

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

under SA § 3(b)(1), or in violation of SA § 5(a) (i.e., the registration requirements), must be "aggregated." [SEC Rule 504(b)(2) (17 CFR § 230.504(b)(2))]

As a practical matter, this means that in determining the amount of securities that can be sold under Rule 504, there must be deducted from the $10 million limit all sales of securities made in the past 12 months under Rule 504 or Regulation A (or in violation of SA § 5(a)).

1) [5:112] **Caution—"continuous" offerings:** Be careful of any "ongoing" offerings that are being conducted simultaneously. If purchases thereunder, when added to other issuances during the 12-month period, go above the $10 million ceiling, the exemption fails … rendering nonexempt *all* issuances, including earlier issuances, made in reliance on the exemption.

(b) [5:113] **Sales made under other exemptions:** However, sales made within the previous 12 months under some *other* exemption not promulgated by the SEC under SA § 3(b)(1) (e.g., intrastate offering, ¶ 5:81; or private placement, ¶ 5:171) will *not* be aggregated in calculating the $10 million ceiling … *unless* such sales are deemed part of the same "integrated" offering. [SEC Rule 504(b)(2) (17 CFR § 230.504(b)(2))]

(c) [5:114] **Integrated offerings (Rule 152); offerings treated as one:** Effective March 15, 2021, the rules governing when separate securities offerings should be "integrated" and treated as one offering have been substantially amended. [See SEC Rule 152 (17 CFR § 230.152); SEC Rel. Nos. 33-10884 & 34-90300 (2020)]

Codified in Rule 152, the integration doctrine is intended to prevent issuers from avoiding registration by artificially dividing a single offering into multiple offerings to take advantage of exemptions that would not apply if the offerings were combined. If the SEC determines that an issuer's transactions are part of a plan or scheme to evade the Securities Act's registration requirements, the SEC will treat two or more offerings as one for the purpose of registration or for qualifying for an exemption from registration—*even if* the transactions technically comply with Rule 152. [See 17 CFR § 230.152; SEC Rel. Nos. 33-10884 & 34-90300, at 11 (2020)]

1) [5:115] **Rule 152's general principle; "facts and circumstances" standard:** For all offerings not covered by one of the safe harbors in SEC Rule 152(b) (¶ 5:116 ff.), whether two or more offerings are to be treated as one for the purpose of registration or qualifying for an exemption from registration is "based on the particular facts and circumstances." In general, offers and sales will not be integrated if the issuer can establish that each offering either (i) complies with the registration requirements, or (ii) is exempt from registration. [SEC Rule 152(a) (17 CFR § 230.152(a)); see SEC Rel. Nos. 33-10884 & 34-90300, at 16, 25-27 (2020)]

This facts-and-circumstances analysis replaces the five-factor test that the SEC previously applied. [SEC Rel. Nos. 33-10884 & 34-90300, at 17, 27 & fn. 35 (2020)]

a) [5:115.1] **Application to exempt offering prohibiting general solicitation:** To avoid integration of an offering that relies on an exemption prohibiting general solicitation (¶ 5:121 ff., 5:173.1 ff.) with another offering, an issuer must reasonably believe, based on the facts and circumstances, that each purchaser in the exempt offering prohibiting general solicitation either (i) was not solicited by the issuer (or any person acting on the issuer's behalf) through the use of general solicitation, or (ii) had a substantive relationship (¶ 5:121.6 ff.) with the issuer (or any person acting on the issuer's behalf) prior to the commencement of the exempt offering prohibiting general solicitation. [SEC Rule 152(a)(1) (17 CFR § 230.152(a)(1)); see SEC Rel. Nos. 33-10884 & 34-90300, at 28 (2020)]

b) [5:115.2] **Application to exempt offerings permitting general solicitation:** In cases where there are two or more concurrent offerings each relying on an exemption permitting general solicitation (¶ 5:181 ff.), the general solicitation offering materials for one offering may constitute an offer of securities for a concurrent offering under a different exemption if the general solicitation offering materials include information about the material terms of the concurrent offering. In such cases, the issuer must comply with all the requirements of *both* exemptions: (i) the exemption permitting the particular general solicitation, and (ii) the exemption permitting the general solicitation for the other concurrent offering, including any legend requirements and communications restrictions. [SEC Rule 152(a)(2) (17 CFR § 230.152(a)(2))]

2) [5:116] **Safe harbors:** No integration analysis is required under SEC Rule 152 if one of four "safe harbors" apply. [SEC Rule 152(b) (17 CFR § 230.152(b))]

a) [5:116.1] **More than 30 days (Rule 152(b)(1)):** An offering will not be integrated with another offering if it is more than 30 calendar days: (i) before the commencement of the other offering (¶ 5:117), or (ii) after the termination or completion of the other offering (¶ 5:117.1). [SEC Rule 152(b)(1) (17 CFR § 230.152(b)(1))]

However, SEC Rule 152(a)(1) (¶ 5:115.1) will apply to any offering that relies on an exemption that prohibits general solicitation and the offering is made 30 calendar days or more after an offering that allows general solicitation. [Rule 152(b)(1) (17 CFR § 230.152(b)(1))]

b) [5:116.2] **Rule 701, employee benefit plan or offshore (Regulation S) offerings (Rule 152(b)(2)):** Under Rule 152(b)(2), three types of offerings will not be integrated with other offerings: (i) offers and sales that comply with SEC Rule 701 (17 CFR § 230.701; ¶ 5:189.1 ff.); (ii) offers and sales pursuant to an employee benefit plan; and (iii) offshore offers and sales that comply with Regulation S (17 CFR § 230.901 et seq.). [SEC Rule 152(b)(2) (17 CFR § 230.152(b)(2))]

c) [5:116.3] **Subsequent registered offerings (Rule 152(b)(3)):** An offering will not be integrated if a registration statement was filed for it and the offering was made after: (i) a terminated or completed offering for which general solicitation was not permitted; (ii) a terminated or completed offering for which general solicitation was permitted and made only to qualified institutional buyers (¶ 5:130 ff.) and institutional accredited investors (¶ 5:174 ff.); or (iii) an offering for which general solicitation was permitted and that terminated or was completed more than 30 calendar days prior to the commencement of the registered offering. [SEC Rule 152(b)(3) (17 CFR § 230.152(b)(3)); *see*¶ 5:117 ff. re commencement, termination or completion of offerings, *and* ¶ 5:121 ff., 5:173.1 ff., 5:181 ff. re general solicitation]

d) [5:116.4] **Offers or sales preceding exempt offerings permitting general solicitation (Rule 152(b)(4)):** Offers and sales made in reliance on an exemption for which general solicitation is not permitted (¶ 5:121 ff., 5:173.1 ff.) will not be integrated if they are made subsequent to any terminated or completed offering (¶ 5:117.1 ff.). [SEC Rule 152(b)(4) (17 CFR § 230.152(b)(4))]

3) [5:117] **Commencement of offerings (Rule 152(c)):** For purposes of SEC Rule 152, an offering of securities commences "at the time of the first offer of securities in the offering by the issuer or its agents." [SEC Rule 152(c) (17 CFR § 230.152(c))]

Rule 152(c) provides additional guidance for determining when certain offerings commence (Rule 152(c) (17 CFR § 230.152(c))):

a) [5:117a] **Offerings relying on Rule 241:** On the date the issuer first made a generic offer soliciting interest in a contemplated securities offering for which the issuer had not yet determined the exemption under the Securities Act under which the offering of securities would be conducted (¶ 5:121.14 ff.). [SEC Rule 152(c)(1) (17 CFR § 230.152(c)(1))]

b) [5:117b] **Offerings relying on SA § 4(a)(2), Regulation D, Rule 147, or Rule 147A:** On the date the issuer first made an offer of its securities in reliance on these exemptions. [SEC Rule 152(c)(2) (17 CFR § 230.152(c)(2))]

c) [5:117c] **Offerings relying on Regulation A:** On the earlier of the date the issuer first made an offer soliciting interest in a contemplated securities offering in reliance on 17 CFR § 230.255, or the public filing of a Form 1-A offering statement. [SEC Rule 152(c)(3) (17 CFR § 230.152(c)(3))]

d) [5:117d] **Offerings relying on Regulation Crowdfunding:** On the earlier of the date the issuer first made an offer soliciting interest in a contemplated securities offering in reliance on 17 CFR § 227.206, or the public filing of a Form C offering statement. [SEC Rule 152(c)(4) (17 CFR § 230.152(c)(4))]

e) [5:117e] **Registration statement:** In the case of a continuous offering that will commence promptly on the date of initial effectiveness, on the date the issuer first filed its registration statement for the offering. [SEC Rule 152(c)(5)(i) (17 CFR § 230.152(c)(5)(i))]

In the case of a delayed offering, on the earliest date on which the issuer (or its agent) commenced public efforts to offer and sell the securities, which could be evidenced by the earlier of (i) the first filing of a prospectus supplement describing the delayed offering, or (ii) the issuance of a widely disseminated public disclosure, such as a press release, confirming the commencement of the delayed offering. [SEC Rule 152(c)(5)(ii) (17 CFR § 230.152(c)(5)(ii))]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Offers to qualified institutional buyers (¶ 5:130.1) and institutional accredited investors (¶ 5:174.1) are not considered commencement of a registered offering. [Rule 152(c)(5)(ii), Note 1 to para. (c)(5) (17 CFR § 230.152(c)(5)(ii))]

4) [5:117.1] **Termination or completion of offerings (Rule 152(d)):** For purposes of Rule 152, an offering is terminated or completed "when the issuer and its agents cease efforts to make further offers to sell the issuer's securities under such offering." [SEC Rule 152(d) (17 CFR § 230.152(d))]

Similar to SEC Rule 152(c) (¶ 5:117 ff.), Rule 152(d) provides additional guidance for determining when certain offerings terminate or complete:

a) [5:117.1a] **Offerings relying on SA § 4(a)(2), Regulation D, Rule 147, or Rule 147A:** On the later of the date that (i) the "issuer entered into a binding commitment to sell all securities to be sold under the offering (subject only to conditions outside of the investor's control)," or (ii) the "issuer and its agents ceased efforts to make further offers to sell the issuer's securities under such offering." [SEC Rule 152(d)(1) (17 CFR § 230.152(d)(1))]

b) [5:117.1b] **Offerings relying on Regulation A:** On any of four dates: (i) the date an offering statement is withdrawn under 17 CFR § 230.259(a); (ii) the date an "exit report" (Form I-Z) is filed under 17 CFR § 239.94 with respect to a Tier I offering under 17 CFR § 230.257(a) (¶ 5:192.6); (iii) the date of an SEC declaration that an offering statement has been abandoned under 17 CFR § 230.259(b) after the offering statement has been on file for nine months without amendment and has not become qualified; or (iv) the date, "after the third anniversary of the date the offering statement was initially qualified," on which 17 CFR § 230.251(d)(3)(i)(F) "prohibits the issuer from continuing to sell securities using the offering statement, or any earlier date on which the offering terminates by its terms." [SEC Rule 152(d)(2) (17 CFR § 230.152(d)(2))]

c) [5:117.1c] **Offerings relying on Regulation Crowdfunding:** On the deadline (i) "identified in the offering materials" under 17 CFR § 227.201(g), or (ii) "indicated by the Regulation Crowdfunding intermediary in any notice to investors delivered" under 17 CFR § 227.304(b). [SEC Rule 152(d)(3) (17 CFR § 230.152(d)(3))]

d) [5:117.1d] **Registration statement withdrawn, abandoned, etc.:** On any of four dates: (i) the date a registration statement is withdrawn after an application for withdrawal is granted or deemed granted under 17 CFR § 230.477; (ii) the date a prospectus supplement or registration statement amendment is filed indicating that the offering (or a particular delayed offering in the case of a shelf registration statement) has been terminated or completed; (iii) the date of an SEC order declaring that a registration statement has been abandoned under 17 CFR § 230.479 after the statement has been on file for nine months and has not become effective; or (iv) the date, "after the third anniversary of the initial effective date of the registration statement," on which 17 CFR § 230.415(a)(5) "prohibits the issuer from continuing to sell securities using the registration statement, or any earlier date on which the offering terminates by its terms." [SEC Rule 152(d)(4) (17 CFR § 230.152(d)(4))]

e) [5:117.1e] **Abandoned or ceased public selling efforts:** In addition, SEC Rule 152(d)(4) provides that an offering could be deemed terminated or completed based on "[a]ny other factors that indicate that the issuer has abandoned or ceased its public selling efforts in furtherance of the offering" (or a particular delayed offering in the case of a shelf registration statement). This could be evidenced by (i) a Current Report on Form 8-K, or (ii) a "widely disseminated public disclosure by the issuer, or its agents, informing the market that the offering" (or particular delayed offering, in the case of a shelf registration statement) has been terminated or completed. [SEC Rule 152(d)(4)(v) (17 CFR § 230.152(d)(4)(v))]

(3) [5:118] **Number and identity of offerees:** There is no limit on the number of investors to whom securities may be issued under this exemption. Nor is there any necessity that such investors be "sophisticated" or possess any particular qualifications, or that they have any previous relationship with the issuer or its principal officers.

(4) [5:119] **Information to investors:** In contrast to the detailed disclosure requirements of the SEC Rule 506 exemption (¶ 5:182 ff.), SEC Rule 504 only requires that investors be furnished with information regarding resale restrictions (when applicable; *see ¶ 5:123 ff.*).

➪ [5:120] ***PRACTICE POINTER:*** However, it is good practice to prepare and distribute a basic offering memorandum in every case. This is most important to protect against claims of "fraud" or "misrepresentation" if the investment proves to be disappointing or fails. (Remember that *anti-fraud rules* apply even if the issuance is exempt from registration; *¶ 5:65*.)

(5) [5:121] **Limitation on advertising or public solicitation:** Except as set forth below (¶ 5:121.1), neither the issuer nor anyone acting on its behalf may offer or sell securities in a SEC Rule 504 offering by any form of general solicitation or public advertising. [SEC Rule 504(b)(1) (17 CFR § 230.504(b)(1)); see SEC Rule 502(c) (17 CFR § 230.502(c))]

(a) [5:121a] **What constitutes "general solicitation":** No specific definition of "general solicitation" is provided. However, Rule 502(d) of Regulation D includes several examples:

- Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio. [SEC Rule 502(c)(1) (17 CFR § 230.502(c)(1))]

- Any seminar where attendees have been invited by general solicitation or general advertising. [SEC Rule 502(c)(2) (17 CFR § 230.502(c)(2))]
  In addition, other uses of publicly available media (e.g., unrestricted websites) can also constitute general solicitation. [*Matter of KCD Fin'l, Inc.* (2017) SA Rel. No. 34-80340—local newspaper articles describing offering in favorable terms constituted general solicitation where based on press release prepared by issuer's broker and posted on broker's website]

(b) [5:121.1] **Exceptions:** Notwithstanding the ban on general solicitation or public advertising (¶ *5:121*), offers and sales in a SEC Rule 504 offering may be made:

- Exclusively in states that require *registration* of the securities and the public filing and delivery to investors of a substantive *disclosure document* before consummating the sale (provided, of course, that the offers and sales are made in accordance with state law); *or*

- In one or more states having no registration or disclosure document requirements so long as (i) the securities have been registered in *at least one state* that provides for registration and the public filing and delivery of a disclosure document before sale, (ii) offers and sales are made in that state in accordance with state law, and (iii) the disclosure document is delivered before sale to *all* purchasers (including those in the states having no disclosure document requirements); *or*

- Exclusively according to state law exemptions from registration that permit general solicitation and general advertising, so long as sales are made only to "accredited" investors (¶ 5:174 ff.). [SEC Rule 504(b)(1) (17 CFR § 230.504(b)(1))]
  1) [5:121.2] **Registration satisfied by California permit:** The SEC Rule 504 "registration" requirement (¶ 5:121.1) will be deemed satisfied in California if the offer and sale are *qualified by permit* and the Financial Protection and Innovation Commissioner requires delivery of a *substantive disclosure document* as a condition of the permit. [See SEC No-Action Letter to Geraldine Greene (Dec. 22, 1982) 1982 WL 30399]

[5:121.3 - 5:121.5] ***Reserved.***

(c) [5:121.6] **Permitted offers/sales—"pre-existing, substantive relationship":** Offers and sales to persons with whom the issuer, or someone acting on behalf of the issuer, has a pre-existing, substantive relationship do *not* constitute general solicitation. [Securities Act Rules Disclosure & Compliance Interpretations, Question 256.26]

(*Note:* Although many of the no-actions letters and Compliance and Disclosure Interpretations cited below arise in the context of SEC Rule 506(b) offerings (¶ 5:173 ff.), they apply as well to SEC Rule 504 offerings. The general ban on advertising and public solicitation is based on SEC Rule 502(c), which applies to both Rule 504 and Rule 506(b) offerings.)

1) [5:121.7] **"Pre-existing":** A "pre-existing" relationship is one that the issuer has formed with an offeree prior to the commencement of the securities offering or, alternatively, that was established through either a registered broker-dealer or investment adviser prior to the registered broker-dealer's or investment adviser's participation in the offering. [Securities Act Rules Compliance & Disclosure Interpretations, Questions 256.28, 256.29]

No minimum duration of time (e.g., 30 days or otherwise) is required to create a pre-existing, substantive relationship. [Securities Act Rules Compliance & Disclosure Interpretations, Question 256.30—no minimum period required to establish pre-existing, substantive relationship; *Citizen VC, Inc.*, SEC No-Action Letter (Aug. 6, 2015) 2015 WL 4699193]

2) [5:121.8] **“Substantive”:** A relationship is “substantive” where the issuer or a person acting on its behalf has sufficient information to evaluate, and does in fact evaluate, a prospective offeree's financial circumstances and sophistication in determining their status as an accredited or sophisticated investor. Self-certification alone (e.g., by checking a box), without any other knowledge of a person's financial circumstances or sophistication, is *not* sufficient to form a “substantive” relationship. [Securities Act Rules Compliance & Disclosure Interpretations, Questions 256.31, 256.32; see *Citizen VC, Inc.*, supra]

3) [5:121.9] **Brokers' advantage over issuers:** Broker-dealers can more easily cultivate a base of potential investors (e.g., through dissemination of investor questionnaires, ¶ 5:121.21) than can issuers. Broker-dealers are subject to regulatory and ethical standards that require attention to the investor's suitability to a particular investment, which provides some degree of investor protection. Absent a prior business relationship or a recognized legal duty to investors, it is likely more difficult for an issuer to establish a pre-existing, substantive relationship … “especially when contemplating or engaged in an offering over the Internet.” [SA Rules Compliance & Disclosure Interpretations Question 256.32; see *AgriStar Global Networks, Ltd.*, SEC No-Action Letter (Feb. 9, 2004) 2004 WL 299067, *discussed at ¶ 5:121.22*]

(d) [5:121.10] **“Demo days” and similar events (Rule 148):** Effective March 15, 2021, and subject to certain restrictions (¶ 5:121.11 ff.), communications made at events known as “Demo days” do not constitute general solicitation or advertising. [SEC Rule 148 (17 CFR § 230.148); SEC Rel. Nos. 33-10884 & 34-90300, at 76-77 (2020)]

1) [5:121.11] **Events covered by “demo day” exemption:** SEC Rule 148 applies to communications “made in connection with a seminar or meeting in which more than one issuer participates that is sponsored by a college, university, or other institution of higher education, State or local government or instrumentality thereof, nonprofit organization, or angel investor group, incubator, or accelerator.” [SEC Rule 148(a) (17 CFR § 230.148(a)); *see*¶ 5:121.13 re definition of “angel investor group”]

2) [5:121.12] **Restrictions:** “Demo day” communications are only exempt if they comply with the following restrictions set forth in SEC Rule 148(a) (17 CFR § 230.148(a)):

a) [5:121.12a] **No advertising:** The issuer's specific securities offering is not referenced in any advertising for the seminar or meeting. [SEC Rule 148(a)(1) (17 CFR § 230.148(a)(1))]

b) [5:121.12b] **No sponsor recommendations, negotiations, fees or compensation:** The sponsor of the seminar or meeting does not: (i) make investment recommendations or provide investment advice to the event's attendees; (ii) engage in any investment negotiations between the issuer and investors attending the event; (iii) charge the event's attendees any fees, except for “reasonable administrative fees”; (iv) receive any compensation for making introductions between the event's attendees and issuers or for investment negotiations between such parties; and (v) receive any compensation in connection with the event that would require the sponsor to register as a broker or dealer under the Securities Exchange Act of 1934 or an investment adviser under the Investment Advisers Act of 1940. [SEC Rule 148(a)(2) (17 CFR § 230.148(a)(2))]

c) [5:121.12c] **Limitation on information communicated:** The information about the offering that is communicated or distributed at or in connection with the event is limited to (i) “a notification that the issuer is in the process of offering or planning to offer securities,” (ii) the type and amount of securities being offered, (iii) the intended use of the offering's proceeds, and (iv) the unsubscribed amount in an offering. [SEC Rule 148(a)(3) (17 CFR § 230.148(a)(3))]

d) [5:121.12d] **Online participation limitations:** If the event allows attendees to participate virtually (rather than in person), online participation is limited to individuals who: (i) are members of or otherwise associated with the sponsor organization; (ii) the sponsor reasonably believes are accredited investors; or (iii) were “invited to the event by the sponsor based on industry or investment-related experience reasonably selected by the sponsor in good faith and disclosed in the public communications about the event.” [SEC Rule 148(a)(4) (17 CFR § 230.148(a)(4))]

3) [5:121.13] **“Angel investor group” defined:** For purposes of SEC Rule 148, “angel investor group” means “a group of accredited investors that holds regular meetings and has defined processes and procedures for making investment decisions, either individually or among the membership of the group as a whole, and is neither associated nor affiliated with brokers, dealers, or investment advisers.” [SEC Rule 148(a)(5) (17 CFR § 230.148(a)(5))]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(e) [5:121.14] **Generic solicitation of interest exemption (Rule 241):** Effective March 15, 2021, an issuer may use generic solicitation of interest materials to determine whether there is any interest in a contemplated securities offering before determining the exemption under which the securities offering will be conducted. [SEC Rule 241(a) (17 CFR § 230.241(a))]

1) [5:121.14a] **No further solicitation until exemption determined:** The issuer cannot solicit or accept any money or any type of commitment (binding or otherwise) from any person until the issuer determines the exemption it will rely on and the offering is commenced in accordance with the exemption's requirements. [SEC Rule 241(a) (17 CFR § 230.241(a))]

2) [5:121.14b] **Conditions:** The generic solicitation of interest materials must state the following (SEC Rule 241(b) (17 CFR § 230.241(b))):

a) [5:121.14c] **No specific exemption determined:** The issuer is considering a securities offering that is exempt from registration, but has not determined the specific exemption. [SEC Rule 241(b)(1) (17 CFR § 230.241(b)(1))]

b) [5:121.14d] **No money or compensation:** No money or other consideration is being solicited and none will be accepted. [SEC Rule 241(b)(2) (17 CFR § 2301.241(b)(2))]

c) [5:121.14e] **No offer can be accepted:** No offer to buy the securities can be accepted and no part of the purchase price can be received until the issuer determines the exemption it will rely on and the requirements of that exemption are met. [SEC Rule 241(b)(3) (17 CFR § 230.241(b)(3))]

d) [5:121.14f] **No obligation or commitments:** A person's indication of interest involves no obligation or commitment of any kind. [SEC Rule 241(b)(4) (17 CFR § 230.241(b)(4))]

(f) [5:121.15] **Other methods of avoiding general solicitation:** There may be circumstances in which an issuer or a person acting on the issuer's behalf can communicate information about an offering to persons with whom it does *not* have a pre-existing, substantive relationship without having that information deemed a general solicitation. Unfortunately, these circumstances are not well delineated. Whether there has been a general solicitation is a fact-specific determination. In general, the greater the number of persons without financial experience, sophistication or any prior personal or business relationship with the issuer who are contacted by an issuer or persons acting on its behalf through impersonal, non-selective means of communication, the more likely the communications are part of a general solicitation. [SA Rules Compliance & Disclosure Interpretations, Question 256.27]

1) [5:121.16] **Investor networks:** There are long-standing practices where issuers and persons acting on their behalf are introduced to prospective investors who are members of an informal, personal network of individuals with experience investing in private offerings. For example, groups of experienced, sophisticated investors, such as “angel investors,” share information about offerings through their network and members who have a relationship with a particular issuer may introduce that issuer to other members. Issuers that contact one or more experienced, sophisticated members of the group through this type of referral may be able to rely on those members' network to establish a reasonable belief that other offerees in the network have the necessary financial experience and sophistication. [SA Rules Compliance & Disclosure Interpretations, Question 256.27]

[5:121.17 - 5:121.19] ***Reserved.***

(g) Examples

• [5:121.20] There is no general solicitation where the general partner of a limited partnership proposed to mail a written offer to approximately 330 persons who had previously invested in other limited partnerships sponsored by the general partner. The issuer (i) had developed pre-existing, substantive business relationships with its prospective offerees within the previous three years and (ii) believed that the investors met specific suitability standards that rendered them sufficiently sophisticated and capable of evaluating the risks and merits of a potential investment. [*Woodtrails-Seattle, Ltd.*, SEC No-Action Letter (Aug. 9, 1982) 1982 WL 29366]

• [5:121.21] A broker-dealer who mailed a letter and suitability questionnaire (to evaluate accreditation and sophistication) to a limited list of professionals and business people on a monthly basis in order to maintain a list of potential investors did not engage in general solicitation *where the contacts were not made in connection with any specific investment currently offered or contemplated*. [*Bateman, Eichler, Hill Richards, Inc.*, SEC No-Action Letter

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(Dec. 3, 1985) 1985 WL 55679; see *E.F. Hutton & Co. Inc.*, SEC No-Action Letter (Dec. 3, 1985) 1985 WL 55680; *H.B. Shaine & Co., Inc.*, SEC No-Action Letter (May 1, 1987) 1987 WL 107907, 1987 WL 108648]

[5:121.22] *Compare:* "No-action" relief was denied to an *issuer* that intended to distribute generic questionnaires to potential investors soliciting information about their sophistication and status as accredited investors even where the distribution was made for the purpose of *future* offerings. [*AgriStar Global Networks, Ltd*., SEC No-Action Letter (Feb. 9, 2004) 2004 WL 299067; *see ¶ 5:121.9*]

• [5:121.23] Securities offered through an unrestricted, publicly available website constitutes general solicitation even if the website requires various forms of information from a prospective investor prior to displaying offering materials. [SA Rel. No. 33-7233 (1995); SA Rules Compliance & Disclosure Interpretations, Question 256.23; see SA Rel. No. 33-7856 (2000); compare *Citizen VC, Inc.*, SEC No-Action Letter (Aug. 6, 2015) 2015 WL 4699193—online venture capital firm that offered LLC interests in special purpose vehicles established substantive relationships with prospective investors through website where investors had to complete online questionnaire and firm subsequently followed up with telephone and email contacts to ensure investor sophistication; *IPONET*, SEC No-Action Letter (July 26, 1996) 1996 WL 431821—broker-dealer that invited prospective investors to complete questionnaire on its website for purpose of building database of accredited and sophisticated investors did not engage in public solicitation where questionnaire did not reference any specific transactions]

[5:121.24 - 5:121.29] ***Reserved.***

(h) [5:121.30] **Dissemination of factual information:** An issuer may widely disseminate factual information about the issuer without engaging in public solicitation so long as the information "does not condition the public mind or arouse public interest in a securities offering." Such factual information must be evaluated on case-by-case basis, but typically should be limited to general information about the issuer's business, financial condition, products and/or services *that is not presented in such a manner as to constitute an offer of the issuer's securities*. Factual information generally *excludes* predictions, projections, forecasts or opinions *with respect to valuation of a security*. [SA Rules Compliance & Disclosure Interpretations, Questions 256.24 & 256.25]

(6) [5:122] **Brokerage commissions:** The issuer can employ brokers or other agents to solicit purchasers on its behalf; and SEC Rule 504 places no limit on the amount or nature of compensation that can be paid to brokers or agents for sales so solicited.

(a) [5:122.1] **Caution—state law/regulatory limitations:** Brokers and agents may be subject to state law and/or regulatory limitations on commissions. [See, e.g., Commr. Rule 260.218.1 (prohibiting broker-dealer and agent from charging customer unreasonable mark-up or commission)]

Although a commission that runs afoul of a state requirement will not ruin the SEC Rule 504 exemption, it may subject a "culpable" issuer to potential state law liabilities (including possible rescission of the transaction).

➪ [5:122.2] ***PRACTICE POINTER:*** Be sure to keep track of the names and addresses of all persons receiving commissions who are associated with (or agents of) brokers or dealers registered with the SEC or any state (e.g., California Department of Financial Protection and Innovation). This information must be listed in the FORM D notice.

(7) [5:123] **Resale restrictions:** With one very important exception (*¶ 5:133*), securities issued under SEC Rule 504 are "restricted" as to resale. [See SEC Rules 502(d), 504(b)(1) (17 CFR §§ 230.502(d), 230.504(b)(1))]

(a) [5:124] **Issuer's responsibilities:** An issuer of "restricted securities" must "exercise reasonable care" to assure that the securities purchasers are not underwriters (within the meaning of SA § 2(a)(11)) and will not publicly distribute the shares. Compliance with the following will demonstrate "reasonable care":

• Obtain *investment representations* from each purchaser to the effect they are buying for investment purposes and not for the purpose of reselling or with a view to public distribution of the stock.

FORM: Investment Representations Letter, *see Form 5:A*.

• Place *restrictive legends* on each share certificate.

FORM: "These shares have been issued under an exemption from registration under the Securities Act of 1933, and have not been registered. These shares cannot be transferred until registered unless a separate exemption from registration applies to such transfer."

• *Disclose to purchasers in writing* that the securities have not been registered and *may not be resold* unless some exemption from registration is available for the resale. [SEC Rule 502(d) (17 CFR § 230.502(d)); see *SEC v. Platforms Wireless Int'l Corp.* (9th Cir. 2010) 617 F3d 1072, 1091-1092—Rule 502(d) requirements not met where securities issued to affiliate that in turn sold them to public and issuer exercised no "reasonable care" to prevent such resales]

[5:124.1 - 5:124.4] ***Reserved.***

(b) [5:124.5] **Certain resales to "accredited" investors (§ 4(a)(7)):** "Restricted securities" may be resold to "accredited" investors (as defined in Reg. D., ¶ 5:174 ff.) in a transaction that does not involve any general solicitation or advertising and that meets certain other requirements.

• If the issuer is not a 1934 Act reporting company, the seller and prospective purchaser must obtain reasonably current specified information regarding the issuer, including the issuer's most recent financial statements;

• The issuer must be "engaged in business," must *not* be in the organizational stage or in bankruptcy or receivership, and must *not* be a so-called "blank check," blind pool or shell company that has no specific business plan or whose primary plan is to merge or combine with an unidentified entity;

• Neither the seller nor any person receiving remuneration for participating in the sale can fall within certain "bad actor" disqualifications; and

• The sale must involve securities of a class that has been outstanding for at least 90 days. [SA § 4(a)(7), (d) (15 USC § 77d(a)(7), (d))]

There is no dollar limit on sales under § 4(a)(7), nor is it relevant whether the seller acquired the securities "with a view to distribution" rather than with investment intent. However, the securities remain "restricted" in the hands of the purchaser for SEC Rule 144 purposes (¶ *5:126*). [See SA § 4(e)(1)(C) (15 USC § 77d(e)(1)(C))]

1) [5:124.6] **State regulation preempted:** A transaction meeting the requirements of SA § 4(a)(7) preempts any state law requiring the qualification of securities or regulating the use of offering documents (except for any "notice filings" and accompanying fees). [SA § 18(b)(4)(G) (15 USC § 77r(b)(4)(G))]

2) [5:124.7] **Private resales—"Section 4(a)(1-1/2) exemption":** Section 4(a)(7) is not the exclusive means for establishing an exemption from the 1933 Act registration requirements for sales of "restricted" securities or other secondary (nonissuer) sales. [SA § 4(e)(2) (15 USC § 77d(e)(2))]

To a certain extent, § 4(a)(7) is a codification of the so-called "Section 4(a)(1-1/2) exemption" for private resales of securities. It is so called because it falls in between the Section 4(a)(1) exemption for persons "other than … an underwriter" and the Section 4(a)(2) exemption for transactions by an issuer "not involving a public offering" (*see* ¶ *5:171*). Arguably, the "Section 4(a)(1-1/2) exemption" remains available for resales of restricted securities outside of § 4(a)(7) (and Rules 144 and 144A, ¶ *5:126 ff.*) if the resales are truly *private* and made to qualified purchasers who do not need the protections afforded by registration. [See *SEC v. Kern* (2nd Cir. 2005) 425 F3d 143, 152; and generally, Committee on Federal Regulation of Securities, ABA Section of Business Law, "Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors—A Report," 66 Bus.Law. 85 (2010)]

No statute or SEC rule expressly sanctions the "Section 4(a)(1-1/2) exemption." But many practitioners rely on it for secondary private placements by nonaffiliate holders of restricted securities in order to avoid the expense and trouble of registering the resale, or selling them under Regulation A (*see* ¶ *5:190*) or relying on the uncertain "intrastate exemption" (SA § 3(a)(11) (15 USC § 77c(a)(11)), ¶ *5:81*).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [5:125] **SEC "safe harbor" resale rules:** The SEC has promulgated certain rules that provide "safe harbors" for resale of "restricted securities"—i.e., those issued in any "nonpublic" offering, including securities issued under the "limited offering" exemption or under SEC Rules 504 or 506 of the Reg. D. "private placement" exemption.

1) [5:126] **Rule 144:** SEC Rule 144 permits unregistered resales of restricted securities that were acquired directly from the issuer. If certain objective criteria are met, the original purchaser will be deemed to have acquired the securities with the requisite investment intent and subsequent resales will *not* destroy the exemption. [See *SEC v. Kern* (2nd Cir. 2005) 425 F3d 143, 148]

Rule 144 is complex; it is briefly described below (¶ 5:127 ff.).

a) [5:127] **Resales by "affiliates":** The following requirements apply to resales of restricted securities by a seller who is an "affiliate" (generally, a "control" person) of the issuer:

• The securities must have been fully paid for and held for a minimum of *six months* if the issuer is a 1934 Act reporting company, and a minimum of *one year* for all other issuers, after which time resales may be made so long as adequate current information regarding the issuer is available to the public;

• Resales during any three-month period cannot exceed the *greater* of (i) an amount equal to *1%* of the outstanding shares of the same class or (ii) the average weekly reported trading volume in the shares during the four weeks preceding the filing of Form 144 or the placing of the sales order;

• Resales must be effected through bona fide *broker-dealer transactions*;

• A Form 144 notice must be filed before selling, in any three-month period, more than *5,000 shares* or shares having an aggregate sales price of more than *$50,000*. [SEC Rule 144(a), (b)(2), (c)-(h) (17 CFR § 230.144(a), (b)(2), (c)-(h)); see SEC Rel. No. 33-8869 (2007); also see *SEC v. Platforms Wireless Int'l Corp.* (9th Cir. 2010) 617 F3d 1072, 1086-1090 (invoking SEC Rule 405 definition of "control" to determine "affiliate" status); *SEC v. Longfin Corp.* (SD NY 2018) 316 F.Supp.3d 743, 758-760—corporate secretary who was actively involved in registration and marketing of issuer's shares and controlled approximately 60% of issuer's public float was "affiliate"]

b) [5:128] **Resales by "nonaffiliates":** Sellers who are not "affiliates" of the issuer (*see*¶ 5:127) are subject to far less stringent requirements under SEC Rule 144:

• Like "affiliates," "nonaffiliates" must have fully paid for the restricted securities and have held them for a minimum of *six months* if the issuer is a 1934 Act reporting company, and a minimum of *one year* for all other issuers;

• After *six months* but before *one year*, unlimited resales are permitted if the issuer is a 1934 Act reporting company and adequate current information about the issuer is publicly available;

• After *one year*, unlimited resales are permitted *without complying with any other SEC Rule 144 requirements*—i.e., "nonaffiliates" can freely resell their securities. [SEC Rule 144(b)(1), (c), (d) (17 CFR § 230.144(b)(1), (c), (d)); see SEC Rel. No. 33-8869, supra; and *SEC v. Kern* (2nd Cir. 2005) 425 F3d 143, 148]

➪ [5:129] ***PRACTICE POINTER:*** You can include appropriate "self-destruct" language in the resale restriction legend placed on "nonaffiliates'" share certificates.

For example: "The above restrictions cease on … (*date*) (*one year after issue)*, and presentation of this certificate for transfer constitutes a representation and warranty by the record holder that he or she has continuously been the beneficial owner of said shares and is free to sell same as a nonaffiliate under SEC Rule 144."

A certificate bearing such a "self-destruct" legend may avoid the time and expense of obtaining a legal opinion on a case-by-case basis that the transfer is exempt under Rule 144.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2) [5:130] **Resales of restricted securities to institutional investors under Rule 144A:** Unregistered securities of the type often issued in private placements and unlikely to be resold to the public may be resold under certain conditions to *qualifiedinstitutional* investors. [See SEC Rule 144A (17 CFR § 230.144A)]

(The Commissioner has adopted regulations to facilitate Rule 144A resales under California law. See Commr. Rule 260.102.10.1, 260.102.15, 260.105.13.1.)

a) [5:130.1] **"Qualified institutional buyer" defined:** A "qualified institutional buyer" is an entity listed in Rule 144A(a)(1)(i) "that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity." [SEC Rule 144A(a)(1)(i) (17 CFR § 230.114A(a)(1)(i)]

The entities listed in Rule 144(a)(1)(i) include:

• Insurance companies;

• Investment companies;

• Small business investment companies;

• Employee benefit plans established by a state or state agency;

• Any trust fund whose trustee is a bank or trust company;

• Business development companies;

• Any charitable or nonprofit organization under IRC § 501(c)(3), corporation (other than a bank or savings and loan association), partnership, limited liability company, or Massachusetts or similar business trust;

• Investment advisers; and

• Any institutional accredited investors, as defined in SEC Rule 501(a) (17 CFR § 230.501(a); ¶ 5:174 ff.). [SEC Rule 144A(a)(1)(i) (17 CFR § 230.114A(a)(1)(i))]

b) [5:131] **Fraud/nondisclosure liability unaffected:** Compliance with SEC Rule 144A and the Commissioner's regulations does not preclude liability under SEC Rule 10b-5 or California law for misrepresentation or intentional failure to disclose. [*OCM Principal Opportunities Fund v. CIBC World Markets Corp*. (2007) 157 CA4th 835, 861, 68 CR3d 828, 853]

[5:132] ***Reserved.***

(d) [5:133] **Exception—Rule 504 "public" offerings:** Resale restrictions are eliminated on securities issued under SEC Rule 504 in circumstances that allow *general solicitation or public advertising*. I.e., offerings registered under a state blue sky law requiring a disclosure document or certain offerings to "accredited" investors (*¶ 5:121 ff.*) produce *freelytrading* securities. [SEC Rule 504(b)(1) (17 CFR § 230.504(b)(1))]

(*Compare: All* securities issued under SEC Rule 506 (¶ 5:184) are "restricted"—i.e., there are no exceptions.)

[5:134 - 5:135] ***Reserved.***

(8) [5:135.1] **Effect of failure to strictly comply with Reg. D requirements—"insignificant deviations":** Failure to comply in all respects with the Reg. D requirements as to *some* investors will *not necessarily* result in loss of the exemption (and hence liability) as to *all* investors. Minor deviations may not be actionable by purchasers if:

• The issuer made a *good faith and reasonable attempt* to fully comply; *and*

• The failure to comply is "*insignificant"* in relation to the offering as a whole. [SEC Rule 508 (17 CFR § 230.508); see *Wright v. National Warranty Co., L.P.* (6th Cir. 1992) 953 F2d 256, 260-261—misrepresentation that investor's wife was accredited investor deemed "harmless error" under Rule 508]

(a) [5:135.2] **Limitation—no deviation from dollar ceiling or general solicitation requirements:** The aggregate dollar offering limitations (*¶ 5:111*) are deemed *significant* to every offering and must be strictly satisfied for a Reg. D exemption to be available. As to these requirements, there is no flexibility or tolerance for minor deviations. [SEC Rule 508 (17 CFR § 230.508)]

(b) [5:135.3] **Minor deviations still actionable by SEC:** In any event, the issuer's failure to fully comply with all of the Reg. D provisions is actionable *by the SEC* … notwithstanding that the noncompliance might amount to an "insignificant" deviation that would not result in loss of the exemption vis-à-vis *purchasers*. [SEC Rule 508(b) (17 CFR § 230.508(b)); see SA § 20 (15 USC § 77t)]

➪ [5:135.4] ***PRACTICE POINTER:*** The SEC Rule 508 flexibility accorded issuers in complying with the Reg. D requirements is intended to protect them only from *inadvertent, isolated* and *minor* failures of compliance … *not* to sanction reduced diligence on their part. Accordingly, *do not relax* your efforts—or existing practices—to establish that the issuer exercised reasonable care to fully comply with Reg. D.

(9) [5:136] **Form D filing required:** A report of securities issued in reliance on any Reg. D exemption must be filed *electronically* on SEC Form D within *15 days* after the first sale. (A due date falling on a weekend or holiday is extended to the next business day.) [SEC Rule 503 (17 CFR § 230.503)]

To file Form D, an EDGAR (Electronic Data Gathering, Analysis and Retrieval System) access code (a "CIK" number) and password must be obtained. Viewing and filing Form D, and obtaining the CIK and password, may be done on the SEC website (*www.sec.gov*). [See Regulation S-T, Rule 10, 17 CFR § 232.10]

(a) [5:137] **Effect of failure to file:** Failure to timely file the Form D notice does *not* result in loss of the exemption, since such filing is no longer a condition to its availability. However, the Form D notice should *always* be filed because an issuer can be disqualified from *future use* of Reg. D if it is enjoined by a court for having previously violated the filing requirements. [SEC Rule 507 (17 CFR § 230.507)]

[5:138 - 5:170] ***Reserved.***

e. [5:171] **Private placement exemption—no $ limit:** The 1933 Act's registration requirements apply only to *public* offerings of securities. Thus, a "private" placement—regardless of the dollar amount—is exempt from these requirements. [SA § 4(a)(2) (15 USC § 77d(a)(2))]

(1) [5:172] **Reg. D, Rule 506:** Because the 1933 Act is vague as to what constitutes a "private" offering or sale of securities, the SEC adopted SEC Rule 506 (successor to former Rule 146) to provide a "safe harbor" as to what constitutes a private placement. [See SEC Rule 506(a) (17 CFR § 230.506)]

As described below, there are in essence two types of private offerings under Rule 506:

- SEC Rule 506(*b*) offerings (*¶ 5:173 ff.*) may not use advertising or public solicitation, and sales may be made only to "accredited" investors and up to 35 "sophisticated" investors.

- SEC Rule 506(*c*) offerings (*¶ 5:181 ff.*) may use advertising and public solicitation, but sales are limited to "accredited" investors.

(a) [5:173] **Rule 506(b) offerings—sales to "accredited" investors and up to 35 "sophisticated" investors with no advertising or public solicitation:** Offers and sales under SEC Rule 506(b) may be made to an unlimited number of "accredited" investors (¶ 5:174 ff.). In addition to sales to accredited investors, the issuer may sell shares to up to 35 other investors (*see ¶ 5:174.11 ff.*) so long as the issuer reasonably believes each such purchaser—either personally or through their "purchaser representative"—has such *knowledge and experience* in financial and business matters that they are *capable of evaluating the merits and risks* of the investment (*see ¶ 5:175 ff.*). [SEC Rule 506(b)(2) (17 CFR § 230.506(b)(2)) & Note thereto]

1) [5:173.1] **General solicitation prohibited:** Neither the issuer nor anyone acting on its behalf may offer or sell securities in a SEC Rule 506(b) offering by any form of general solicitation or public advertising. This ban encompasses articles or other communications appearing in newspapers, magazines or other media, as well as seminars or meetings whose attendees have been invited by general solicitation or advertising. [SEC Rule 506(b)

(1) (17 CFR § 230.506(b)(1)); see SEC Rule 502(c) (17 CFR § 230.502(c)); see also *Matter of KCD Financial, Inc. (2017) SA Rel. No. 34-80340*, *discussed at ¶ 5:121*]

a) [5:173.2] **Permitted offers/sales—"pre-existing, substantive relationship":** This is the same as under SEC Rule 504 offerings. *See ¶ 5:121.6 ff.*

b) [5:173.3] **Other methods of avoiding general solicitation:***See ¶ 5:121.15 ff.*

c) [5:173.4] **Dissemination of factual information:***See ¶ 5:121.30*.

d) [5:173.5] **"Demo days" and similar events:***See*¶ 5:121.10 ff.

2) [5:174] **"Accredited" investors defined:** SEC Rule 501 defines "accredited" investors as including the following:

a) [5:174.1] **Institutional investors:** Any bank, savings and loan association, or credit union; any SEC-registered broker-dealer; any registered investment adviser; any insurance company; any investment company or business development company registered under the Investment Company Act of 1940 (15 USC § 80a-1 et seq.) or small business investment corporation; any rural business investment company; any employment benefit plan qualified under ERISA (or established by state or local governments) with over $5 million in assets. [17 CFR § 230.501(a)(1)]

b) [5:174.2] **Private business development companies:** As defined in § 202(a)(22) of the Investment Advisors Act of 1940 (generally, a company operated for the purpose of acquiring controlling interests in certain small businesses and which makes available significant managerial assistance to such businesses). [17 CFR § 230.501(a)(2)]

c) [5:174.3] **Charities:** Any nonprofit charitable or educational organization qualified under IRC § 501(c)(3) with assets of more than $5,000,000. [17 CFR § 230.501(a)(3)]

d) [5:174.3a] **Business entities:** Any corporation, Massachusetts or similar business trust, partnership, limited liability company, or charitable or nonprofit organization under IRC § 501(c)(3) having more than $5 million in total assets and not formed for the specific purpose of acquiring the offered securities. [17 CFR § 230.501(a)(3)]

e) [5:174.4] **Insiders:** Any director, executive officer or general partner of the issuer, or of the issuer's general partner. [17 CFR § 230.501(a)(4)]

f) [5:174.5] **Wealthy investors:** Anyone with annual individual income exceeding $200,000 (or $300,000 including spouse) during each of the past two years, and reasonable expectation of same for the current year. [17 CFR § 230.501(a)(6)]

Also, anyone with a net worth (including spouse) exceeding $1 million, not including value of primary residence. Debt secured by residence, up to its estimated fair market value at time of securities sale, is not included as a liability (except that if debt at time of securities sale exceeds amount outstanding 60 days before sale, other than as result of acquiring residence, excess is included as a liability). Debt secured by the residence in excess of estimated fair market value at time of securities sale is included as a liability. [17 CFR § 230.501(a)(5)]

A "spousal equivalent" (i.e., a "cohabitant occupying a relationship generally equivalent to that of a spouse") may be included when determining a person's joint income or net worth. [17 CFR § 230.501(j)]

g) [5:174.5a] **Trusts:** Any trust with more than $5 million in total assets, not formed for the specific purpose of acquiring the offered securities, and where purchase of the securities is directed by a person having sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment (per SEC Rule 506(b)(2)(ii)). [17 CFR § 230.501(a)(7)]

h) [5:174.6] **Wholly-owned entities:** Any entity that is wholly-owned by investors in any of the preceding categories. [17 CFR § 230.501(a)(8)]

i) [5:174.6a] **Catch-all category:** Any entity that is not otherwise covered by SEC Rule 501(a) (e.g., Indian tribes, labor unions, governmental bodies and funds, and sovereign wealth funds) that owns investments in excess of $5 million and is not formed for the specific purpose of investing in the offered securities. [17 CFR 230.501(a)(9); see 17 CFR 270.2a51-1(b) (defining "investments")]

j) [5:174.6b] **Certified professionals:** Natural persons who have professional certifications, designations or credentials, such as a Series 7, 65 or 82 securities license, from an accredited educational institution. [17 CFR § 230.501(a)(10)]

k) [5:174.6c] **Knowledgeable employees:** Natural persons who qualify as "knowledgeable employees" of the issuer under the Investment Company Act of 1940. [17 CFR § 230.501(a)(11); see 17 CFR 270.3c-5(a)(4) (defining "knowledgeable employee" as company's "executive officer, director, trustee, general partner, advisory board

member, or person serving in a similar capacity," or employee "who, in connection with his or her regular functions or duties, participates in [company's] investment activities")]

l) [5:174.6d] **Family offices:** Any company that qualifies as a "family office" under the Investment Advisers Act of 1940, has at least $5 million in assets under management, that is not formed for the specific purpose of investing in the offered securities, and whose prospective investment is directed by a "person who has such knowledge and experience in financial and business matters that such family office is capable of evaluating the merits and risks of the prospective investment." [17 CFR § 230.501(a)(12); see 17 CFR 275.202(a)(11)(G)-1(b) ("family office" only has "family clients" (¶ 5:174.6e), is wholly owned by "family clients" (¶ 5:174.6e), is exclusively controlled by one or more family members and/or family entities, and "does not hold itself out to the public as an investment adviser")]

m) [5:174.6e] **Family clients:** A "family client" (as defined by the Investment Advisers Act of 1940) of a family office (¶ 5:174.6d) whose prospective investment is directed by the family office. [17 CFR 230.501(a)(13); see 17 CFR 275.202(a)(11)(G)-1(d)(4) (defining "family client" as any current or former family member, key employee, and their estates, trusts, non-profit/charitable organizations, and wholly-owned companies)]

3) [5:174.7] **Compare—California rules:** "Accredited" investors are likewise excluded when counting the maximum number of permitted purchasers under Corps.C. § 25102(f) (¶ 5:265).

Additionally, California excludes investors who purchase *at least $150,000* of the offered securities, regardless of the form of consideration (does not have to be cash, etc.). But such purchasers either must have the capacity to protect their own interests or their investment must be limited to no more than *10%* of their net worth. *See ¶ 5:272*.

[5:174.8 - 5:174.10] ***Reserved.***

4) [5:174.11] **Not more than 35 "sophisticated" ("nonaccredited") investors:** In addition to sales to "accredited" investors, the issuer may sell securities to what the issuer reasonably believes are not more than 35 other ("nonaccredited") investors. (But the issuer must reasonably believe that these investors are "sophisticated;" *see ¶ 5:173*.) [SEC Rule 506(b)(2)(i) (17 CFR § 230.506(b)(2)(i)) & Note to Paragraph (b)(2)(i); see SEC Rule 501(e) (17 CFR § 230.501(e))]

a) [5:174.12] **Spouses:** Spouses are counted as *one purchaser,* as is any relative of either spouse who has the *same principal residence* as the purchaser. [SEC Rule 501(e)(1)(i) (17 CFR § 230.501(e)(1)(i))]

(Compare: The comparable exemption from qualification under California's Corporate Securities Law, Corps.C. § 25102(f), now has the same rule; see Commr. Rule 260.102.13(c), ¶ 5:262.)

b) [5:174.13] **Controlled entities:** Any trust, estate, corporation or other organization which is more than 50% owned by a purchaser (or a spouse or relative residing with the purchaser) is excluded in computing the number of "nonaccredited" investors. [SEC Rule 501(e)(1)(ii), , (iii) (17 CFR § 230.501(e)(1)(ii), (iii))]

(Compare: Again, similar rules apply under the California exemption. See Commr. Rule 260.102.13(c)(2), (3), ¶ 5:263.)

c) [5:174.14] **Entities:** A corporation, partnership or other entity counts as a single purchaser (regardless of the number of its shareholders, partners or owners), unless it was specifically formed for the purpose of making such investment and not *all* of its equity owners are "accredited" investors. [SEC Rule 501(e)(2) (17 CFR § 230.501(e)(2))]

(California is in accord. See Corps.C. § 25102(f)(4), *¶ 5:264*.)

• [5:174.15] **Example:** An existing investment partnership, consisting of two "accredited" couples (¶ 5:174.5) and three "nonaccredited" couples, would be counted as a single purchaser … so long as the partnership was not formed for the specific purpose of acquiring the securities. (If formed for that specific purpose, it would be counted as three purchasers—i.e., the three "nonaccredited" couples.)

5) [5:175] **Verifying investor qualifications:** Issuers commonly use detailed written questionnaires to establish that proposed investors meet the financial requirements for "accredited" status (¶ 5:174 ff.) or are "sophisticated" enough to evaluate the investment (¶ 5:173). The issuer's good faith and reasonable reliance on information furnished by the proposed investor establishes their accredited status. [SEC Rule 501(a) (17 CFR § 230.501(a)); see *Wright v. National*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Warranty Co., L.P. (6th Cir. 1992) 953 F2d 256, 260—issuer could rely on plaintiff officer's representation that he and wife were accredited investors]

Caution: An investor's self-certification as an "accredited" investor is *not* sufficient to establish "accredited" status in SEC Rule 506(c) offerings (involving general solicitation); *see ¶ 5:181 ff.*

• ***FORM:*** Offeree Questionnaire, *see Form 5:C*.

6) [5:176] **"Purchaser representative":** Where a purchaser representative is relied upon to provide the requisite sophistication, they must be someone designated *in writing* by the investor as the investor's "purchaser representative." [SEC Rule 501(i)(3) (17 CFR § 230.501(i)(3))]

a) [5:177] **Qualifications:** The purchaser representative must be someone whose advice can supply the requisite sophistication to an investor who otherwise lacks it. Thus, the purchaser representative must possess such knowledge and experience in financial and business matters that they are capable of evaluating alone, or together with the investor or other representatives of the investor, the merits of the proposed investment. [SEC Rule 501(i)(2) (17 CFR § 230.501(i)(2))]

Examples: Such representative should ordinarily be a *professional* advisor—an investment broker, licensed broker-dealer, investment counselor, etc. (An attorney or accountant may, but often does not, possess the requisite qualifications.)

b) [5:178] **Independent of issuer:** The purchaser representative may *not* be an affiliate, director, officer or employee of the issuer. Further, except in limited, specific circumstances, they may not own 10% or more equity interest in the issuer. [SEC Rule 501(i)(1) (17 CFR § 230.501(i)(1))]

c) [5:179] **Disclosure to investor:** A reasonable time before the sale, the purchaser representative must have disclosed to the investor *in writing* any material relationship with the issuer during the past two years, or presently being contemplated, *including* any compensation received or to be received on account of such relationship. [SEC Rule 501(i)(4) (17 CFR § 230.501(i)(4))]

7) [5:180] **Compare—California rule:** The "sophistication" requirements are similar under Corps.C. § 25102(f); but that statute allows as an *alternative* ground for exemption the investor's *pre-existing relationship* with the issuer or its principals (*see ¶ 5:278*).

Moreover, the California rule requires a *professional financial advisor*, rather than simply a "purchaser representative," where the investor lacks the requisite business and financial experience (*see¶ 5:282*).

(b) [5:181] **Rule 506(c) offerings—advertising and public solicitation permitted but sales limited to "accredited" investors:** There are *no* restrictions on advertising and public solicitation, and *no* limit on the number of purchasers, so long as the corporation takes "reasonable steps" to verify that *all* purchasers are "*accredited" investors* (¶ 5:174 ff.). [SEC Rule 506(c)(1), (2)(i), (ii) (17 CFR § 230.506(c)(1), (c)(2)(i), (c)(2)(ii)); *see ¶ 5:175*]

1) [5:181.1] **"Safe harbor" verification methods for natural persons:** SEC Rule 506 also provides "safe harbor" methods of verifying that individuals (including married couples) are "accredited" investors (*see ¶ 5:174.5*). [SEC Rule 506(c)(2)(ii) (17 CFR § 230.506(c)(2)(ii)) & Instruction 1 thereto]

a) [5:181.2] **Income verification:** To verify an individual's income, it suffices to review any IRS form (W-2, 1099, 1040, etc.) that reports income for the two most recent years *and* obtain a written representation that the individual has (or, in the case of a married couple, they have) a reasonable expectation of reaching the income level necessary to qualify as an "accredited" investor during the current year. [SEC Rule 506(c)(2)(ii)(A) (17 CFR § 230.506(c)(2)(ii)(A)) & Instruction 2 thereto]

b) [5:181.3] **Net worth verification:** To verify an individual's net worth, it suffices to review, so long as dated within three months prior to the securities sale, (i) bank statements or brokerage statements, certificates of deposits, tax assessments, and/or appraisal reports issued by independent third parties, *and* (ii) a consumer report from at least one nationwide consumer reporting agency. In addition, the individual (or married couple) must represent in writing that all liabilities necessary to make a determination of net worth have been disclosed. [SEC Rule 506(c)(2)(ii)(B) (17 CFR § 230.506(c)(2)(ii)(B)) & Instruction 3 thereto; SA Rules Compliance & Disclosure Interpretations, Question 260.08]

c) [5:181.4] **Alternative—verification by professional:** Instead of examining income and net worth documentation from the investor, the corporation may rely upon a written confirmation from a registered broker-

dealer, an SEC-registered investment adviser, or a licensed attorney or certified public accountant attesting that the professional has taken reasonable steps, within three months prior to the securities sale, to verify the "accredited" status of the investor. [SEC Rule 506(c)(2)(ii)(C) (17 CFR § 230.506(c)(2)(ii)(C)); see SA Rules Compliance & Disclosure Interpretations, Question 260.08]

d) [5:181.4a] **Certification (pre-9/23/13):** If a person purchased securities as an accredited investor prior to September 23, 2013, and continues to hold those securities, a corporation may rely on a certification that it received from the person at the time of sale that they qualify as an accredited investor. [SEC Rule 506(c)(2)(ii)(D) (17 CFR § 230.506(c)(2)(ii)(D))]

e) [5:181.4b] **Written representation:** If a corporation previously took reasonable steps to verify that an investor was an accredited investor in accordance with SEC Rule 506(c)(2)(ii), the corporation may rely on a written representation from the investor at the time of a subsequent sale that the investor continues to qualify as an accredited investor, as long as the corporation is not aware of any information to the contrary. [SEC Rule 506(c)(2)(ii)(E) (17 CFR § 230.506(c)(2)(ii)(E))]

2) [5:181.5] **Relationship between "reasonableness" of verification and method of offering:** The nature of the offering—such as the means through which the issuer publicly solicits purchasers—may be relevant in determining the reasonableness of the steps taken to verify accredited investor status. For example, an issuer that solicits new investors through a website accessible to the general public, through a widely disseminated email or social media solicitation, or through print media, such as a newspaper, will likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party. [SEC Rel. No. 33-9415 (2013), p. 33]

(c) Disclosure requirements

1) [5:182] **Offerings to "nonaccredited" investors:** SEC Rule 506(b) offerings to "nonaccredited" investors are subject to detailed disclosure requirements set forth in SEC Rule 502. (The disclosure requirements vary depending upon the size of the issue and whether or not the issuer is already a "reporting company" under the 1934 Act.) [SEC Rule 506(b)(1) (17 CFR § 230.506(b)(1))]

a) [5:182.1] **Reporting companies:***Reporting companies* must furnish the most recently-filed annual report, proxy statement, 10-K annual report, etc., together with any more current filings. [SEC Rule 502(b)(2)(ii)(A)-(C) (17 CFR § 230.502(b)(2)(ii)(A)-(C))]

b) Nonreporting companies

1/ [5:182.2] **Nonfinancial information:** An issuer eligible to use Regulation A (*see ¶ 5:190 ff.*) must provide the same kind of nonfinancial information as required by Part II of Form 1-A. Otherwise, it must provide the same kind of information as required in Part I of a registration statement on the registration form (*see ¶ 5:49*) the issuer would be entitled to use. [SEC Rule 502(b)(2)(i)(A) (17 CFR § 230.502(b)(2)(i)(A))]

2/ [5:182.3] **Financial information:** For offerings of up to $20 million, the issuer must furnish the financial information required by paragraph (b) of Part F/S of Form 1-A and which must be prepared in accordance with generally accepted accounting principles in the United States (US GAAP). [SEC Rule 502(b)(2)(i)(B)(1) (17 CFR § 230.502(b)(2)(i)(B)(1))]

For offerings over $20 million, financial information required by paragraph (c) of Part F/S of Form 1-A. [SEC Rule 502(b)(2)(i)(B)(2) (17 CFR § 230.502(b)(2)(i)(B)(2))]

2) [5:182.4] **Offerings to "accredited" investors:** There are no specific disclosure requirements for securities offered and sold to "accredited" investors. Such investors are deemed able to fend for themselves in extracting information from the issuer. [SEC Rule 506(c)(1) (17 CFR § 230.506(c)(1)); see SEC Rule 502(b)(1) (17 CFR § 230.502(b)(1))]

(d) [5:183] **State regulation preempted:** The SEC adopted SEC Rule 506 as a "safe harbor" for issuers using the SA § 4(a)(2) "private placement" exemption. It thus *preempts* concurrent state regulation; i.e., securities offerings conducted in reliance on Rule 506 are *exempt from state qualification requirements* (except for a "notice" filing and accompanying fees, *¶ 5:185.1*). [SA § 18(a), (b)(4)(F), (c)(2) (15 USC § 77r(a), (b)(4)(F), (c)(2)); Corps.C. § 25102.1(d); *see¶ 5:18.5 ff.*]

(e) [5:183.1] **Integrated offerings:***See discussion at*¶ 5:114 ff.

(f) [5:184] **Resale restrictions and "safe harbor" rules:** These are the same as under SEC Rule 504, ¶ 5:123 (except that SEC Rule 506, unlike Rule 504, has no exception that produces freely tradable securities if registered under state law or sold in exempt "public offerings" to "accredited" investors; i.e., *all* securities issued under Rule 506 are "restricted"). [SEC Rule 506(b)(1), (c)(1) (17 CFR § 230.506(b)(1), (c)(1)); see SEC Rule 502(d) (17 CFR § 230.502(d))]

(g) [5:184.1] **"Insignificant deviations" from requirements:** SEC Rule 508 relief for "insignificant deviations" applies to SEC Rule 506 offerings to the same extent as to other Reg. D offerings (*see*¶ *5:135.1 ff.*) … *except* that failure to comply with the 35 purchaser limit (SEC Rule 506(b)(2)(i), ¶ *5:173*) is deemed "significant." [SEC Rule 508(a)(2) (17 CFR § 230.508(a)(2))]

(h) [5:184.2] **"Bad actor" disqualification:** The corporation may be disqualified from relying on SEC Rule 506 if certain persons connected to the corporation or the offering (e.g., directors, executive officers, promoters, 20%-or-more shareholders) were convicted of securities- or fraud-related crimes or were the subject of adverse regulatory or court orders. Disqualification will not occur, however, if the corporation shows it did not know, and in the exercise of reasonable care could not have known, of the conviction or order. Nor will pre-September 23, 2013 convictions or orders disqualify the corporation from using Rule 506 so long as they are disclosed to investors. [See SEC Rule 506(d), (e) (17 CFR § 230.506(d), (e))]

(i) [5:185] **Report of sale on Form D:** As with sales under SEC Rule 504, the issuer must file a Form D with the SEC (*see* ¶ *5:136*). [SEC Rule 503(a)(1) (17 CFR § 230.503(a)(1))]

1) [5:185.1] **California filing requirement:** A copy of the Form D that was filed with and accepted by the SEC must also be filed with the Department of Financial Protection and Innovation within *15 days* after the *first* sale in California, and must be accompanied by a $300 filing fee. Late filings will be considered filed if accompanied by the filing fee, "but shall not constitute an acknowledgment by the Department that the issuer has met the requirements of federal law or the CSL." [Commr.Rel.No. 109-C (revised 2007); see Corps.C. §§ 25102.1(d), 25608.2; Commr.Rel.No. 120-C (revised 2018); Commr.Rel.No. 115-C (revised 2004)]

a) [5:185.2] **Filing by mail:** The Form D may be mailed, together with the filing fee and a consent to service of process, to any of the following Department offices (Commr.Rel.No. 120-C, supra):

• 1515 K St., Ste. 200
Sacramento, CA 95814

• One Sansome St., Ste. 600
San Francisco, CA 94104-4428

• 320 West 4th St., Ste. 750
Los Angeles, CA 90013-2344

b) [5:185.3] **Filing electronically:** Alternatively, the Form D may be filed electronically, and payment made, either at the Department's online self-service portal DocQNet (*https://docqnet.dfpi.ca.gov*) or at the North American Securities Administrators Association Electronic Filing Depository (*http://www.nasaa.org*). No consent to service of process is necessary when making an electronic filing. [Commr.Rel.No. 120-C, supra]

c) [5:185.4] **Restrictions on amended filings:** Amendments to the Form D need not be filed with the Department. An amendment will be accepted only if it (i) indicates "Informational Filing Only," (ii) is not accompanied by a fee, and (iii) includes a reference to the original file date and the original "Cal-EASI" package ID (*see* ¶ *5:185.5*). [Commr.Rel.No. 120-C, supra; Commr.Rel.No. 109-C, supra]

1/ [5:185.5] **"Cal-EASI" superseded by DOCQNET:** Cal-EASI, or California Electronic Access to Securities & Franchise Information, was the Department's original online database containing securities and franchise filings. It was replaced by DocQNet in 2014. The package ID can now be obtained at *https://docqnet.dfpi.ca.gov*.

➪ [5:185.6] ***PRACTICE POINTER:*** Include a transmittal letter stating that the Form D is filed pursuant to SEC Rule 506 and § 18(b)(4)(F) (formerly § 18(b)(4)(D)) of the Securities Act of 1933. [See Commr.Rel.No. 103-C (1996), as superseded by Commr.Rel.No. 120-C, supra (predating 2012 and 2015 amendments redesignating SA § 18(b)(4)(D) as § 18(b)(4)(F))]

(2) [5:186] **Private placement exemption outside Rule 506 (SA § 4(a)(2) exemption):** The Regulation D exemptions are *not* exclusive. Nor does failure to meet their requirements raise any presumption that the offering is not exempt. Thus, an issuer may claim a sale is exempt as a "private placement" under § 4(a)(2) of the 1933 Act, even though it fails to qualify under SEC Rule 506. [See Regulation D, Preliminary Note 3]

[5:186.1] **Example:** An issuer's failure to meet the 35-purchaser limit or to timely file a Form D report (as required by SEC Rule 506) does *not* necessarily mean that registration was required: The issuer may still attempt to show that a "private" placement was made.

➪ [5:186.2] ***Caveat—no preemption of state regulation:*** Where an issuer is relying on the § 4(a)(2) exemption but is not relying on Rule 506 (or any other rule that may be adopted by the SEC under § 4(a)(2)), the offering is subject to applicable state regulation. The § 4(a)(2) statutory exemption for "private placements" does *not* preempt concurrent state regulation; only *SEC rules* adopted under § 4(a)(2) (presently, only SEC Rule 506) can preempt state regulation. [SA § 18(a), (b)(4)(F) (15 USC § 77r(a), (b)(4)(F)); *see* *¶ 5:18.6*]

(a) [5:187] **Case law as to what constitutes "private" offering:** Courts have refused to lay down any fixed rule to delineate what is a "public" vs. "private" offering. The number of offerees by itself is *not* determinative; nor is the existence (or lack) of relationship with the issuer or each other. Rather, the ultimate issue is whether, under the particular circumstances of the offering, *potential* purchasers—i.e., the offerees—*need the protection* of the 1933 Act registration provisions. [See *SEC v. Ralston Purina Co.* (1953) 346 US 119, 125, 73 S.Ct. 981, 984; and generally, Committee on Federal Regulation of Securities, ABA Section of Business Law, Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors—A Report, 66 Bus.Law. 85 (2010)]

As stated by the Supreme Court, "[s]ince exempt transactions are those as to which 'there is no practical need for (the bill's) application,' the applicability of § 4[(a)](2) should turn on whether the particular class of persons affected *need* the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering' [and thus exempt under the Act]." [*SEC v. Ralston Purina Co.*, supra (emphasis added)]

(b) [5:188] **SEC criteria:** In an attempt to formulate a more objective yardstick, the SEC has formulated certain criteria as to what constitutes a "public," as opposed to "private," offering. The principal factors to be considered are:

- The *number* of offerees and their *relationships* to each other and to the issuer (and its directors, officers, and promoters);
- The *size* of the offering and number of shares being offered (the larger the number, the more likely it will end up in the hands of the public);
- The *manner* of the offering (personal contacts suggest private offering, whereas use of brokers or sales reps indicates public);
- *Qualifications* of all the *offerees* as well as the purchasers (the more sophisticated the prospective investors, the more likely they can fend for themselves, and the less likely it will be treated as a "public" offering); and
- What *information* has been disclosed (the more material facts have been disclosed, or full access thereto is provided, the less likely it will be treated as a "public" offering). [SEC Rel. No. 4552 (1962); see, e.g., *Mark v. FSC Secur. Corp.* (6th Cir. 1989) 870 F2d 331, 333]

➪ [5:189] ***PRACTICE POINTER:*** Do *not* advise your clients to rely on the statutory "private placement" exemption. It is impossible to predict whether a court will agree that the offering is "private," should a disgruntled investor or the SEC challenge the offering.

Wherever possible, attempt to structure the offering to meet SEC Rule 506 requirements (¶ 5:172 ff.). Or, if that is not possible, consider whether the offering could be exempt under SEC Rule 504 or the intrastate offerings exemption (Rules 147 or 147A).

In short, rely on the statutory "private placement" exemption only when all else fails.

When such reliance is necessary, plan the transactions to be as "private" as possible. Do everything you can to assure that:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- *All offerees* (not just those who purchase) are reasonably believed to possess the kinds of qualifications contained in Rule 506;
- They have been furnished with material information necessary to make an informed investment decision;
- They are buying for their own account rather than with the intent to resell;
- They are "relatively few" in number; and
- They were contacted personally, rather than through brokers or by general solicitation or, if the offering will be conducted pursuant to SEC Rule 506(c) and will involve general solicitation, advise your client to follow the rules for verification of accredited investor status of all purchasers in the offering (only accredited investors may purchase the securities in a private offering involving general solicitation under Rule 506(c)).

f. [5:189.1] **Exemption for compensatory benefit plans (Rule 701):** Rule 701 exempts from registration offers and sales by *nonreporting* companies of their securities pursuant to written employee benefit or compensation plans between the issuer (or its parents or majority-owned subsidiaries) and employees, directors, general partners, trustees, officers, consultants and advisors. [SEC Rule 701]

(1) [5:189.2] **Annual ceiling on securities sales:** While there is no ceiling on the amount of securities that may be *offered* under such plans, the aggregate sales price or amount of securities that may be *sold annually* cannot exceed the *greatest* of (a) $1 million, (b) 15% of the issuer's total assets, or (c) 15% of the outstanding securities of the class being offered and sold. [SEC Rule 701(d)(2) (17 CFR § 230.701(d)(2))]

Further, if more than $10 million of securities are sold in any consecutive 12-month period, specified disclosures must be provided to each purchaser. [SEC Rule 701(e) (17 CFR § 230.701(e))]

(2) [5:189.3] **Resale restrictions:** Securities issued under SEC Rule 701 are "restricted securities" and cannot be resold without registration or an exemption from registration. [SEC Rule 701(g) (17 CFR § 230.701(g))]

(3) [5:189.4] **No integration with other offerings:** Offers and sales under SEC Rule 701 are deemed to constitute a single, discrete offering and are *not* subject to integration with any other offers and sales, whether registered or otherwise exempt from registration under the 1933 Act. [SEC Rule 701(f) (17 CFR § 230.701(f))]

(4) [5:189.5] **No preemption of state law:** SEC Rule 701 does *not* preempt concurrent state regulation (*see*¶ *5:18.5 ff.*). However, California law expressly exempts securities offered or sold under Rule 701 from state qualification so long as certain requirements are met. [Corps.C. § 25102(o); *see*¶ *5:305*]

g. [5:190] **Regulation A "short form" registration for up to $75 million:** Regulation A, now also known as Reg. A+ because of its two-tiered structure, is an exemption from full registration for public offerings authorized by the SEC under SA § 3(b)(2). It provides a simplified registration procedure for public offerings of up to $75 million in securities in any 12-month period. [SEC Rules 251-263 (17 CFR § 230.251 et seq.)]

(1) [5:190.1] **Tier 1 offerings:** Tier 1 of Reg. A permits offerings within a 12-month period of up to *$20,000,000* (including up to $6,000,000 in secondary sales by affiliates of the issuer). The $20,000,000 limit includes all securities sold pursuant to all Reg. A offering statements within the 12-month period. [SEC Rule 251(a)(1) (17 CFR § 230.251(a)(1))]

(a) [5:190.2] **No preemption of state regulation:** Unlike Tier 2 offerings (*see* ¶ *5:190.6*), Tier 1 offerings do *not* preempt concurrent state regulation. Thus, a Tier 1 offering must still comply with all applicable state requirements. (But California requirements are not onerous; *see* ¶ *5:199*.) [SA § 18(a), (b)(4) (15 USC § 77r(a), (b)(4)); *see* ¶ *5:18.5 ff.*]

(2) [5:190.3] **Tier 2 offerings:** Tier 2 of Reg. A permits offerings of up to *$75 million* (including up to $22.5 million in secondary sales by affiliates of the issuer). [SEC Rule 251(a)(2) (17 CFR § 230.251(a)(2))]

(a) [5:190.4] **Investor restrictions:** Unless the securities are listed on a registered national securities exchange, sales under Tier 2 are restricted to:

- "*Accredited*" investors (as defined in SEC Rule 501; *see* ¶ *5:174 ff.*);
- Other *natural persons* so long as the aggregate purchase price is no more than 10% of the *greater* of their *annual income or net worth* (excluding the value of their primary residence); and

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Other *entity* investors so long as the aggregate purchase price is no more than 10% of the *greater* of their *revenues or net assets* for their most recently completed fiscal year. [SEC Rule 251(d)(2)(i)(C) (17 CFR § 230.251(d)(2)(i)(C))]

1) [5:190.5] **Reliance on investor representations:** The issuer may rely on the investor's representation when determining compliance with the 10% limitation so long as the issuer does not know at the time of sale that any such representation is untrue. [SEC Rule 251(d)(2)(i)(D) (17 CFR § 230.251(d)(2)(i)(D))]

(b) [5:190.6] **State securities laws preempted:** All offerees and purchasers in a Tier 2 offering are deemed to be "qualified purchasers" (*see ¶ 5:18.6*). This has the effect of preempting state securities law requirements, other than notice filings (*see ¶ 5:190.7*). [SEC Rule 256 (17 CFR § 230.256); see *Lindeen v. SEC* (DC Cir. 2016) 825 F3d 646, 653-658 (upholding validity of Rule 256)]

1) [5:190.7] **California notice filing required:** An issuer planning to offer and sell securities in California to "qualified purchasers" must submit the following before the initial offer in California:

• A copy of the Form 1-A filed with the SEC (*see ¶ 5:192*);

• A consent to service of process or a statement that the issuer is a California corporation (but a consent to service of process is not required if the Form 1-A was filed with the SEC electronically); and

• A filing fee of $600. [Corps.C. § 25102.1(a); Commr.Rel.No. 122-C (2015)]

a) [5:190.8] **Annual filings; amendments:** The notice filing does not require annual renewals. In the case of amendments to the Form 1-A, a cover letter should be submitted that states "Informational Filing Only" and that includes the DocQNet Organization ID and Notice ID, which may be obtained from the Department's website (*www.dfpi.ca.gov*). There is no filing fee for amendments. [Commr.Rel.No. 122-C, supra]

(3) [5:191] **Issuer qualifications:** Reg. A is available to most issuers, but not to investment companies, business development companies or "blank check" companies (¶ 5:110). [SEC Rule 251(b) (17 CFR § 230.251(b))]

(a) [5:191.1] **"Bad actor" disqualification:** Additionally, an issuer may *not* use Reg. A if certain persons connected to the corporation or the offering (e.g., directors, executive officers, promoters, 20%-or-more shareholders) were convicted of securities- or fraud-related crimes or were the subject of adverse regulatory or court orders. Disqualification will not occur, however, if the issuer shows it did not know, and in the exercise of reasonable care could not have known, of the conviction or order. Nor will pre-June 19, 2015 convictions or orders disqualify the issuer from using Reg. A so long as they are disclosed to investors. [SEC Rule 251(b)(8) (17 CFR § 230.251(b)(8)), SEC Rule 262 (17 CFR § 230.262)]

(4) [5:191.2] **Additional limit on secondary sales:** Secondary sales of selling security holders may not exceed 30% of the aggregate offering price of a particular offering in (a) the issuer's first Reg. A offering or (b) any subsequent Reg. A offering qualified within one year of the qualification date of the issuer's first offering. [SEC Rule 251(a)(3) (17 CFR § 230.251(a)(3))]

(5) [5:191.3] **"Testing the waters" ("solicitation of interest") before preparing offering statement:** Before actually going to the expense of preparing and filing an offering statement (*¶ 5:192*), an issuer may solicit interest by publishing factual information about itself and its business to assess investor interest. Written communications may include a response form by which a prospective investor can indicate interest in the offering by furnishing the investor's name, address, telephone number, and/or email address. Any oral or written communications used to solicit investor interest must state that (i) *no money will be accepted* and *no sales can be made* until the offering statement is qualified with the SEC, and (ii) an indication of interest involves *no obligation or commitment of any kind*. [SEC Rule 255(a)-(c) (17 CFR § 230.255); *see*¶ 5:106.16a ff. re "testing the waters" rule (SEC Rule 206) for Regulation Crowdfunding issuers]

(6) [5:192] **Qualification process; disclosure requirements:** The issuer must prepare an *offering statement* (on Form 1-A) containing an *offering circular*. (Disclosure requirements are more extensive in Tier 2 offering circulars; notably, financial statements must be *audited* (*¶ 5:192.2*).) Although *offers* may commence upon filing of Form 1-A, no *sales* may be made until the SEC determines the offering statement to be "qualified" (i.e., declared effective). During this time, the statement is screened by SEC staff in a process similar to that given to a regular registration statement and offering prospectus (*see¶ 5:54 ff.*). If the SEC concludes further disclosures are required, it will advise the issuer to amend the

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

offering statement; or it may obtain a stop order, if necessary. [SEC Rules 251(d), 252, 253, 254 (17 CFR §§ 230.251(d), 230.252, 230.253, 230.254)]

(a) [5:192.1] **Confidential filing of preliminary offering statements (first-time Reg. A issuers):** Once the offering statement is filed with the SEC, it becomes a public record accessible to anyone through the SEC's EDGAR database (¶ *5:48*). However, issuers that have not previously sold securities pursuant to a Reg. A offering or registration statement may submit a *draft* offering statement for *nonpublicreview* by the SEC staff. If the issuer decides to proceed with the offering, the draft offering statement, all amendments thereto and all related correspondence with the SEC staff (subject to any separately approved confidential treatment request) must then be publicly *filed* with the SEC staff. The offering statement may not be declared effective less than 21 days thereafter. [SEC Rule 252(d) (17 CFR § 230.252(d))]

(b) [5:192.2] **Required financial statements:** Both Tier 1 and Tier 2 issuers must file balance sheets and related financial statements for the two previous fiscal years (or for such shorter time that they have been in existence). Tier 2 issuers must include audited financial statements in their offering circulars. The latest financial statements included in the offering circular must be dated not more than nine months before the date of submission, with the most recent annual or interim balance sheet not older than nine months. [SEC Rule 252(a) (17 CFR § 230.252(a)); Form 1-A, Part F/S(b), (c)]

(c) [5:192.3] **Delivery of preliminary offering circular:** As stated above (¶ *5:192*), no securities sales may be made until the offering is qualified. Additionally, if before the offering was qualified any prospective investors indicated an interest in purchasing the securities, the issuer must deliver a *preliminary* offering circular to such investors *at least 48 hours in advance of any sale*. (But this requirement does not apply to a Tier 2 issuer that is current in its post-qualification reporting obligations (¶ *5:192.6*).) [SEC Rule 251(d)(2)(i)(B) (17 CFR § 230.251(d)(2)(i)(B))]

(d) [5:192.4] **Final offering circular—electronic delivery permitted:** In most circumstances, a final offering circular must be delivered to the purchaser not more than *two business days after the sale*. This requirement may be satisfied under an "access equals delivery" model through electronic filings on the SEC's EDGAR system: In lieu of actual delivery of the final offering circular, purchasers may be provided with a notice where the URL with the final offering circular may be obtained, including contact information for obtaining a final offering circular. [SEC Rule 251(d)(2)(ii)(E) (17 CFR § 230.251(d)(2)(ii)(E))]

(e) [5:192.5] **Delayed offerings:** Offerings must be completed while the information disclosed in the offering circular and (offering statement) is current and accurate. Ordinarily, this means offerings must be completed within *30 days after qualification*. However, Reg. A permits issuers to conduct *continuous* offerings of securities that are reasonably expected to be sold within *two years after initial qualification*, but with a *maximum* sales period of *three years after qualification*. Before the end of the three-year period, the issuer may file a new offering statement. Until the new offering statement is qualified, securities may continue to be sold under the prior offering statement (but not beyond the three-year period). Issuers in a continuous or delayed *Tier 2* offering must remain current in their annual and semi-annual post-qualification reporting obligations (¶ *5:192.6*). [SEC Rule 251(d)(3)(i) (17 CFR § 230.251(d)(3)(i))]

(7) [5:192.6] **Post-qualification reporting requirements:** *Tier 1* issuers must file an exit report (Form 1-Z) within 30 days after the offering. [SEC Rule 257(a) (17 CFR § 230.257(a))]

Tier 2 issuers are subject to more extensive periodic and "current event" reporting requirements following the offering. (SEA reporting companies are deemed to meet the Tier 2 reporting requirements.) [SEC Rule 257(b) (17 CFR § 230.257(b))]

(8) [5:192.7] **Integration with other offerings:** *See discussion at* ¶ 5:114 ff.

(9) [5:192.8] **Effect of failure to strictly comply with Reg. A requirements—"insignificant deviations":** Failure to comply with the Reg. A requirements as to *some* investors will not necessarily result in loss of the exemption (and hence liability as to) *all* investors. Minor deviations may not be actionable if:

• The failure to comply did not pertain to a requirement *directly intended to protect those particular investors*;

• The failure to comply is "*insignificant*" in relation to the offering as a whole; and

• The issuer made a *good faith and reasonable attempt* to fully comply with Reg. A. [SEC Rule 260(a)(1)-(3) (17 CFR § 230.260(a)(1)-(3))]

(a) [5:192.9] **Limitation—no deviation from offering limitations or issuer qualifications:** The offering limitations (¶ 5:190 ff.), including the maximum dollar amounts (¶ *5:190.1, 5:190.3*), and the issuer qualifications (¶ *5:191*) are deemed *significant* to every offering and must be strictly satisfied for a Reg. A offering to be available. As to these requirements, there is no flexibility or tolerance for minor deviations. [SEC Rule 260(a)(2) (17 CFR § 230.260(a)(2))]

(b) [5:192.10] **Minor deviations still actionable by SEC:** In any event, the issuer's failure to fully comply with all the Reg. A provisions is actionable *by the SEC* … notwithstanding that the noncompliance might amount to an "insignificant" deviation that would not result in loss of the exemption vis-à-vis *purchasers*. [SEC Rule 260(b) (17 CFR § 230.260(b)); see SA § 20 (15 USC § 77t)]

(10) [5:193] **Antifraud rules still apply:** Since Reg. A is not a formal registration statement, there is no basis for civil liability under SA §§ 11 or 12 of the 1933 Act for misstatements or omissions therein. However, the antifraud provisions of SEC Rule 10b-5 (¶ *6:360 ff.*) would clearly apply to any such misstatements or omissions, including those made when "testing the waters" (¶ *5:191.3*). [See SEC Rule 255(a) (17 CFR § 230.255(a))]

(11) [5:194] **No resale limitations:** Securities sold under Reg. A are *not* "restricted" and therefore are not subject to the resale limitations of SEC Rule 144 (¶ 5:126). [SA § 3(b)(2)(C) (15 USC § 77c(b)(2)(C))]

(12) [5:194a] **Permit by coordination:** Offers (but not sales) for which a *Tier 1* offering statement has been *filed* (*see* ¶ *5:192*) are *exempt* from qualification under California law. Tier 1 *sales* may be qualified by the expedited *coordination* process (¶ *5:199 ff.*). [Corps.C. §§ 25102(b), 25111(a)]

(As stated above (¶ *5:190.6*), state securities law requirements are *preempted* in *Tier 2* offers and sales.)

(13) [5:194b] **Exemption from 1934 Act registration (Tier 2 issuers):** Ordinarily, issuers having more than $10 million in total assets and more than 2,000 record equity holders (or more than 500 record equity holders who are not accredited investors) must register the securities under the 1934 Act. The issuer then becomes subject to the reporting requirements, proxy solicitation rules, short-swing profit rules, and other provisions of the 1934 Act. [See SEA § 12(g) (15 USC § 78*l*(g))]

However, securities issued by Tier 2 issuers are exempt from the SEA's mandatory registration requirements so long as the issuer:

- Engages the services of a *transfer agent* that is *registered with the SEC*;
- Remains subject to Tier 2 post-qualification reporting obligations (¶ *5:192.6*) and is *current* in the filing of its reports; and
- Has a public float of *less than $75 million* as of the last business day of its most recently completed semi-annual period or, in the absence of any public float, had annual revenues of *less than $50 million* as of its most recently completed fiscal year. [SEC Rule 12g5-1(a)(7) (17 CFR § 240.12g5-1(a)(7))]

h. [5:194.1] **Judicial or administrative approval upon fairness hearing (SA § 3(a)(10) exemption):** Securities issued upon approval by any federal court or authorized government agency are exempt from the other provisions of the 1933 Act. To obtain such approval, a hearing must be held on the fairness of the terms and conditions of the issuance. [SA § 3(a)(10) (15 USC § 77c(a)(10)); see SEC Rel. No. 33-312 (1935); Commr.Rel.No. 102-C (revised 1998)]

This exemption is broadly available for issuance of securities in exchange transactions in California (¶ 5:194.3).

➪ [5:194.1a] ***Caveat—preemption of state regulation:*** The SA § 3(a)(10) exemption does *not* preempt concurrent state regulation. (Conceptually, of course, it makes no sense for federal law to preempt state law where the securities are issued following a Financial Protection and Innovation Commissioner hearing and approval sought in order to qualify for the § 3(a)(10) exemption.) [SA § 18(b)(4)(E) (15 USC § 77r(b)(4)(E)); see Commr.Rel.No. 102-C (revised 1998)]

(1) [5:194.2] **Requirements:** To be exempt under SA § 3(a)(10), the securities issuance must meet the following requirements:

(a) [5:194.3] **Securities issued in exchange transaction:** The securities must be issued "in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash." [SA § 3(a)(10) (15 USC § 77c(a)(10))]

Thus, the exemption is available for corporate mergers and other reorganizations (¶ *8:161 ff.*), or any other exchange transaction (whether in public offerings or offerings that otherwise qualify as "private placements" exempt under SA § 4(a)(2), ¶ 5:186.2).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) [5:194.4] **Fairness hearing:** In addition, all prospective recipients of the securities must be given the opportunity to appear at a hearing on the fairness of the terms and conditions of the issuance. The hearing may be held by any federal court or any federal or state governmental authority expressly authorized by law to approve such an issuance. [SA § 3(a)(10) (15 USC § 77c(a)(10))]

1) [5:194.5] **Hearing and approval by Financial Protection and Innovation Commissioner:** The California Financial Protection and Innovation Commissioner is expressly authorized to hold these hearings. [Corps.C. § 25142]

Thus, an exchange of securities qualified for issuance by the Commissioner after hearing is exempt from federal registration requirements under SA § 3(a)(10).

(2) [5:194.6] **No resale restrictions:** So long as they are not affiliates or underwriters, recipients of securities issued under SA § 3(a)(10) should be able to resell their shares without being restricted by Rule 144 (*see¶ 5:126*). [SA § 4(a)(1) (15 USC § 77d(a)(1))]

Indeed, resale restrictions do not apply even if § 3(a)(10) securities are issued in exchange for “restricted” securities (e.g., in exchange for shares issued under SA § 4(a)(2) or Reg. D exemptions). [See *St. Ives Holding Co. Inc.*, SEC No-Action Letter (July 22, 1987) 1987 WL 108169]

➪ [5:194.7] ***PRACTICE POINTER:*** To take advantage of the greater transferability of SA § 3(a)(10) securities, issuers in an exchange transaction should consider applying for qualification and requesting a “fairness hearing” by the Financial Protection and Innovation Commissioner—even if the issuance would otherwise be exempt in California (e.g., under § 25102(f)).

[5:194.8 - 5:194.10] ***Reserved.***

i. [5:194.11] **Securities offerings in bankruptcy proceedings:** Offers and sales of securities made in connection with bankruptcy proceedings generally are exempt from the 1933 Act registration requirements (as well as California state law qualification requirements). [11 USC §§ 364, 1145(a),(b); see also 11 USC §§ 1125(e), 1129(d)]

Cross-refer: For a detailed discussion of these bankruptcy exemptions, see March & Shapiro, *Cal. Prac. Guide: Bankruptcy* (TRG), Ch. 14 Part II.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 5-C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations

Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 5. Share Issuance:
Securities Law Considerations

C. California Securities Law Requirements

- 1. [5:195a] Qualification Requirement—In General
  - a. [5:195.1] Scope of California statute
    - (1) [5:195.2] Jurisdictional limitation
      - (a) [5:195.2a] Application
      - (b) [5:195.2b] Caution—federal preemption
    - (2) [5:195.3] "Security"
      - (a) [5:195.3a] "Risk capital" and "*Howey*" tests employed
        - 1) [5:195.3b] Application of "risk capital" test
          - a) [5:195.3c] Factors to consider
      - (b) [5:195.3d] Jury must decide if a "security" exists in criminal cases
    - (3) [5:195.4] "Sale" or "offer to sell"
      - (a) [5:195.4a] Caution—includes changes in shareholder rights
      - (b) [5:195.4b] Limitation—community property division not a "sale"
    - (4) [5:195.5] Exempt securities
      - (a) Other exempt and/or "preempted" securities
        - 1) [5:195.5a] Secured promissory notes
        - 2) [5:195.5b] Securities of "listed" corporations
        - 3) [5:195.5c] Investment company securities
        - 4) [5:195.5d] Compare—exempted/"preempted" *transactions*
      - (b) [5:195.6] Antifraud rules still apply
  - b. [5:196] Qualification compared to federal registration
  - c. Methods of qualification
    - (1) [5:197] Qualification by permit
      - (a) [5:197.1] Procedure
    - (2) [5:198] Qualification by notification
      - (a) [5:198.1] Exemption for listed securities
      - (b) [5:198.2] Note re investment company securities
      - (c) [5:198.3] Commissioner's authority to refuse, suspend or revoke qualification
    - (3) [5:199] Qualification by coordination
      - (a) [5:199.1] Commissioner's authority to refuse, suspend or revoke qualification
        - 1) [5:199.2] Underwritten offerings
        - 2) [5:199.3] Offerings not underwritten
    - (4) [5:199.4] Comment

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- 2. [5:200] Exemptions From Qualification
  - a. [5:201] Exemption for "private" offers and subscriptions (NOT sales)
    - (1) [5:202] Application
    - (2) [5:203] Offering "nonpublic" if limited to 35 persons
      - (a) [5:204] Computation of 35-person limit
      - (b) [5:205] Compare—offerings to more than 35 persons
        - 1) [5:207] Negotiation permit required for "public" offers
    - (3) [5:208] Subscription agreements must be conditioned on qualification
    - (4) [5:210] No disclosure requirement
      - (a) [5:211] Compare—federal exemptions
  - b. [5:212.5] Exemption for Internet offerings (*not* sales)
    - (1) [5:212.6] Federal preemption re crowdfunding offerings
  - c. [5:212.10] Exemption for offerings filed with SEC
  - d. [5:213] Exemption for "private" sales of debt securities
    - (1) [5:214] Applies only to debt securities
      - (a) [5:215] Not convertible debt
        - 1) [5:216] Comment
    - (2) [5:217] "Nonpublic" transactions
      - (a) [5:218] Limited to 25 offerees
      - (b) [5:219] Limited to 10 purchasers
      - (c) [5:220] Offeree qualifications
      - (d) [5:221] Computation of 25 and 10 person limits
      - (e) [5:222] Compare—offerings or sales to more persons
      - (f) [5:223.5] Filing requirement in offerings by realty-related issuers
        - 1) [5:223.6] Contents of notice
        - 2) [5:223.7] Where to file notice
        - 3) [5:223.8] No filing fee
    - (3) [5:223.11] Compare—exemption for notes secured by realty
      - (a) [5:223.12] Limitations imposed by Business and Professions Code
    - (4) [5:223.15] Compare—exemption for limited *sales* by real estate brokers of realty-secured notes
  - e. [5:224] Exemption for closely-held corporations (§ 25102(h))
    - (1) [5:225] Only one class of shares outstanding
      - (a) [5:226] Debt securities not stock
      - (b) [5:227] Shares subject to restrictions
        - 1) [5:228] Impact on statutory close corporations
    - (2) [5:229] No more than 35 beneficial owners
      - (a) Computation of 35-person limit
    - (3) Consideration for which shares issued
      - (a) [5:234] If shares issued to only one person
      - (b) [5:235] If shares issued to more than one person
    - (4) Restrictions on manner of sale
      - (a) [5:240] No general solicitation
      - (b) [5:241] No selling expenses
    - (5) [5:242] Purchaser representations (resale restrictions)
      - (a) [5:242.1] *Written* representations recommended
        - 1) [5:242.2] Investment letter
        - 2) [5:242.3] Subscription agreement
      - (b) [5:242.4] No specific holding period
      - (c) [5:242.5] Intent not to sell in any "distribution"

(d) [5:242.6] Prior law resale restriction and legend condition removed
(6) [5:243] Available to SPCs
(7) [5:244] Notice to Department of Financial Protection and Innovation Commissioner
(a) [5:245] Contents
(b) [5:246] Consent to service
(c) [5:247] Attorney opinion required
(d) Filing requirements
1) [5:249] Time
a) [5:250] Exception
b) [5:250.1] Otherwise, within 15 days after demand or discovery of failure to file
2) [5:251] Fee
a) [5:251.1] Late filing penalty
3) [5:252] Mailing
(e) [5:253] Failure to file does *not* destroy exemption
(f) [5:254] Additional notice required for realty-related issuers
(8) Comment—“pros and cons” of § 25102(h) exemption
(a) [5:255] Disadvantages
(b) [5:255.1] Advantage
f. [5:256] Limited offering exemption (§ 25102(f))—“utility infielder” exemption
(1) [5:257] “Offer or sale”
(a) [5:258] Exception—issuer's own retirement plan
(b) [5:259] Exercise of stock options, etc.
(2) [5:260] “Any security”
(3) [5:261] “Not more than 35 purchasers”
(a) Computing the 35-person limit
1) [5:262] Family purchases count as one
2) [5:263] Controlled entities
3) [5:264] Other entities
(b) [5:265] Excluded purchasers
1) [5:266] Institutional purchasers
2) [5:267] Officers, directors or affiliates
a) [5:268] If the issuer is a…
b) [5:269] Also excluded is any other…
c) [5:270] Also excluded is any entity…
3) [5:271] Promoters
4) [5:272] $150,000 purchasers
a) [5:274] Compare—Reg. D
5) [5:275] “Accredited” investors
6) [5:276] “Wholly-owned entities”
7) [5:276.1] Verifying excluded status
a) [5:276.2] Reliance on purchaser representations
b) [5:276.2a] Compare—Rule 506(c) offerings
(4) Qualifications of counted purchasers
(a) [5:277] Tests for qualification
1) [5:278] “Pre-existing relationship” test
a) [5:278.1] Objective standard utilized
2) [5:279] “Financial experience” test
a) [5:279.1] Applied from issuer's point of view
(b) [5:280] *Each* “counted” purchaser must qualify

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [5:281] Excluded purchasers need not qualify
(d) [5:282] Professional advisor qualifications
1) [5:283] Compare—federal rule
2) [5:284] Need not be registered investment advisor
3) [5:284.1] Attorneys, accountants and others
4) [5:285] Disclosures of adverse interest not sufficient
(5) [5:286] Purchaser representations
(a) [5:287] In writing
1) [5:287.1] Investment letter
2) [5:287.2] Subscription agreements
(b) [5:288] No specific holding period
(c) [5:289] Intent not to sell in any “distribution”
1) [5:290] Comment
2) [5:291] Where distribution contemplated
(6) [5:292] Prohibition on advertising or general solicitation
(a) [5:293] Limited disseminations permitted
1) [5:293.1] Application
2) [5:293.2] Caution
(7) [5:294] Notice to Department of Financial Protection and Innovation Commissioner
(a) [5:294.1] Online filing required
1) [5:294.2] Hardship exception
(b) [5:294.5] Filing copy of Form D
(c) [5:295] Failure to file notice does *not* destroy exemption
(d) Time limits for filing notice
1) [5:297] Within 15 days after first sale
2) [5:298] Otherwise, within 15 days after demand or discovery of failure to file
(e) [5:299] Fee
1) [5:299.1] Late filing penalty
(f) [5:299.5] Commissioner's authority unaffected by filing of notice
(g) [5:300] Consent to service of process
(h) [5:300.1] Additional notice required for realty-related issuers
(8) [5:301] Comment—usefulness of § 25102(f) exemption
(a) [5:301.1] Entity conversions
(b) [5:302] Compare
1) [5:303] Issuances to “strangers”
2) [5:304] Certain reorganizations
g. [5:304.6] “Qualified purchaser” limited public offering exemption (§ 25102(n))
(1) [5:304.7] Purpose
(2) [5:304.8] No limit on amount of offering or number of offerees or purchasers
(a) [5:304.9] *Caution*—offerings exceeding $5 million
(3) [5:304.10] “Qualified purchasers”
(a) [5:304.11] Natural persons meeting high suitability standards as “qualified purchasers”
1) [5:304.12] Sophistication
2) [5:304.13] Financial ability
3) [5:304.14] Disclosure statement
a) [5:304.15] Disclosure requirement not applicable to § 25102(f) “excluded” purchasers
1/ [5:304.16] Caveat—Rule 506 offerings over $5 million
b) [5:304.17] Exemption not lost by disclosure defects

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(4) [5:304.19] Public solicitation
(a) [5:304.20] Mandatory contents of announcement
(b) [5:304.21] Optional contents
(5) [5:304.22] Purchaser's representations
(6) [5:304.23] Limitations on issuers and transactions
(7) [5:304.24] Notices to Commissioner
(a) [5:304.25] Time of filing
(b) [5:304.26] Undertaking to file disclosure statement
(c) [5:304.27] Filing fee
(d) [5:304.28] Online filing
(e) [5:304.29] Exemption lost for failure to file first notice/fee
(f) [5:304.30] Additional notice required for realty-related issuers
h. [5:305] Exemption for stock option/purchase plans
(1) [5:305.1] Exemption conditions
(2) [5:305.2] Notice to Commissioner
(a) [5:305.2a] Online filing
(b) [5:305.3] Exemption not defeated by failure to file notice
(3) [5:305.4] Previously qualified issuance—exemption available for plan amendments
(a) [5:305.5] Amendment requiring qualification—new notice and fee required
(4) [5:305.6] No integration with other offers/sales
i. [5:305.10] Exemption for securities exchanged in merger or asset sale
j. [5:305.15] Exemption for licensed “capital access company” securities
(1) [5:305.16] “Capital access company” defined
(2) [5:305.17] “Accredited investors”
(a) [5:305.18] Pre-existing relationship or investment experience also required
(b) [5:305.19] California residency restriction
(c) [5:305.20] Legend restricting transfer
(3) [5:305.21] Intrastate offerings—no general solicitation or advertising
(4) [5:305.22] Licensing requirements
(5) [5:305.23] Continuous regulation
k. [5:305.24] Exemption for small offerings
(1) [5:305.25] Comment
(2) [5:305.26] Qualifying corporations
(3) [5:305.27] Issuers must ensure non-accredited investors' knowledge and experience
(4) [5:305.28] Purchaser's right to rescind
(5) [5:305.29] Funds raised must be placed in escrow account
(6) [5:305.30] Direct solicitation by issuers prohibited
(7) [5:305.31] Waiver of purchasers' rights prohibited
(8) [5:305.32] Notice of transactions and payment of fee required
l. [5:306] Other exempted/“preempted” transactions
(1) [5:306.1] Certain *out-of-state* offers or sales…
(2) [5:307] Offers or sales of a…
(3) [5:307.1] Any bona fide secured transaction…
(4) [5:308] Offers or sales of ownership…
(5) [5:309] *Incentive stock options* issued by…
(6) [5:309.1] Certain recapitalization and exchange transactions.…
(7) [5:309.3] Offers and sales of *debt*…
(8) [5:309.4] Exchange-traded *options* on stock indices…
(9) [5:309.5] Offers or sales of *guarantees*,…

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(10) [5:309.6] Nonpublic offerings of equipment trust…
(11) [5:309.7] Issuances to specified financial and…
(12) [5:309.7a] Offers or sales incident to…
(13) [5:309.8] Offerings pursuant to a plan…
(14) [5:309.9] Offerings of interests in oil…
(15) [5:309.10] Offers and sales to "qualified…
m. [5:310] Caution—antifraud rules still applicable
n. [5:311] Caution—exemptions jeopardized by "integrated offerings"
(1) [5:312] Factors affecting whether several offerings deemed "integrated"
(2) [5:313] Example
(3) [5:313.5] No integration of securities issued pursuant to option plans/agreements
(4) [5:314] Safe harbors
(a) [5:314.2] Qualified offers or sales
(5) [5:314.3] Avoiding integration outside safe harbors
3. [5:315] Nonexempt Issues; Procedure for Obtaining Permit
a. [5:316] Application for permit
(1) [5:316a] Standard application
(a) [5:316.1] Filing fee
(b) [5:316.1a] Online filing
(2) [5:316.2] "Small company application for permit"
(a) [5:316.3] Issuer qualifications
(b) [5:316.4] Common vs. preferred stock
(c) [5:316.4a] $1 million offering limit
(d) [5:316.5] $2 per share minimum price
(e) [5:316.5a] Two-year moratorium on transactions affecting capital structure
(f) [5:316.6] Use of proceeds
(g) [5:316.7] Contents of disclosure document
(h) [5:316.8] Execution by majority of directors
(i) [5:316.9] Filing fee
(3) [5:316.15] "Small business issuer" application for permit
(a) [5:316.16] Issuer qualifications
(b) [5:316.17] Investor suitability standards
(c) [5:316.18] Guidebook delivery requirement
(d) [5:316.19] Merit standards relaxed
1) [5:316.20] Business plan
2) [5:316.21] Promotional shares
3) [5:316.22] Pricing of securities
4) [5:316.23] Selling expenses
5) [5:316.24] Financial statements
b. [5:317] Discretion of Department of Financial Protection and Innovation Commissioner
c. [5:318] Standards for granting or refusal of permit
(1) [5:320] "Seasoned" vs. "unseasoned" businesses
(2) [5:321] "Open" vs. "limited" permits
(a) [5:322] Review of selling price
1) [5:322.1] Compare—"small business issuer"
(3) [5:323] Feasibility of business plan
(a) [5:323.1] Waiver for "small business issuer"
(4) Capital structure
(a) [5:324] Seasoned businesses

(b) [5:325] Unseasoned businesses
(5) [5:327] Restrictions on transfer
(6) [5:329] Limitations on promotional shares
(a) [5:330] "Promotional shares"
(b) [5:331] Waiver of dividends, assets on liquidation or preferences
(c) [5:332] Restrictions on transfer; legend on share certificates
(7) [5:334] Limitations on outstanding stock options, warrants, rights
(a) [5:335] Options to employees
(b) [5:336] Pro rata options to existing shareholders
1) [5:336.1] Presumption of reasonableness
2) [5:336.2] Caution re below-market options
(c) [5:337] Warrants to holders of debt securities
(d) [5:338] Warrants accompanying stock purchases
(e) [5:339] Options to underwriters
(f) [5:340] Exception for Rule 701 plans
(8) [5:341] Limitations on selling expenses
(a) [5:342] "Selling expenses"
(b) [5:342.1] Compare—"small business issuer"
(9) [5:342.5] Financial statements
(a) [5:342.6] Relaxed requirements for "small business issuer"
(10) [5:343] Other standards relating to rights of security holders
d. [5:350] Permit may be granted conditionally
(1) [5:351] Waiver of rights on promotional shares
(2) [5:352] Impound conditions
(a) [5:353] Such impound condition normally will…
(b) [5:354] A depository (local bank) is…
(3) [5:355] Transfer restrictions
(4) [5:356] Escrow conditions
e. [5:357.5] Commissioner's authority to monitor issuer and revoke permit
f. [5:357.6] Required semi-annual reports for 18 months following qualification
(1) [5:357.7] Contents
4. [5:358] Enforcement Provisions
a. [5:358.1] Effect of choice of law and forum selection clauses; waiver
b. [5:359] Statutory liability for violation of qualification requirements
(1) [5:360] Who may sue
(a) [5:361] Original purchasers
(b) [5:362] Compare—subsequent purchasers
(2) [5:363] Scope of recovery
(a) [5:364] Rescission
1) [5:364.1] Rescissionary damages against control persons and aiders/abettors?
(b) [5:365] Damages
(c) [5:365.1] No offset for tax benefits
(d) [5:366] No punitive damages
(e) [5:367.1] Attorney fees
(3) [5:368] Who may be held liable
(a) [5:369] Issuer
1) [5:369.1] Issuer absolutely liable
(b) [5:370] Underwriter
1) [5:371] Limitation on liability

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [5:372] Persons vicariously liable because of relationship to violator
1) [5:377] “Due diligence” defense available
(d) [5:377.1] Aiders and abettors
1) [5:377.2] Scienter required
(e) [5:377.6] Rescissionary damages available against control persons and aiders/abettors?
(4) [5:378] Indemnification and contribution among defendants
(5) [5:379] Duration of liability
(a) [5:380] Statute of limitations
1) [5:381] Effect
2) [5:382] “Discovery of the facts constituting the violation”
3) [5:383] Fraudulent concealment as extending statute
4) [5:384] Fraudulent representations as extending statute
(b) [5:386] Effect of repurchase offers
1) [5:387] Contents
2) [5:388] Application for approval by Financial Protection and Innovation Commissioner
a) [5:388.1] Consent to service of process
b) [5:388.2] Online filing
3) [5:389] Conditions
(6) [5:389.6] Effect of federal preemption of qualification requirement
(a) [5:389.7] Example—reliance on Rule 506 (Reg. D)
c. [5:390] Statutory liability for misrepresentation
(1) [5:392] Who may sue—“privity” required
(a) [5:393] Compare—subsequent purchasers
(b) [5:393.1] Compare—administrative enforcement action seeking restitution
(2) [5:394] Scope of recovery
(a) [5:395] Rescission
1) [5:395.1] Rescissionary damages against control persons and aiders/abettors?
a) [5:395.4] Comment
(b) [5:396] Damages
1) [5:396.1] Compare—aggrieved seller's damages
a) [5:396.2] Rescission available
(c) [5:397] No punitive damages
(d) [5:398.1] Attorney fees and costs
(3) Who may be held liable
(a) [5:399] Violator (seller)
1) [5:399.1] Direct “privity” required
a) [5:399.2] Analogous federal law (SA § 12(a)(2)) distinguished
2) [5:400] Defenses available
(b) [5:401] Persons vicariously liable because of relationship to violator
1) [5:406] Vicarious liability
2) [5:407] Defense
(c) [5:408] Aiders and abettors
1) [5:409] Intent to defraud required
2) [5:409.1] Direct relationship to violation required
3) [5:409.3] Compare—no “substantial assistance” liability under Corps.C. § 25403
(d) [5:410] Persons certifying information
1) [5:411] Conditions for liability
a) [5:411.1] Effect of no written consent
1/ [5:411.2] Comment

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2) [5:412] Defenses
(e) [5:412.5] *Not* government entities
(f) [5:412.6] Limitation—rescission only against sellers
(4) [5:413] Contribution among defendants
(5) [5:414] Two-year/five-year statute of limitations
(a) [5:414.1] Accrual upon inquiry notice
(b) [5:415] Compare—common law fraud
(c) [5:416] Compare—qualification violations
(d) [5:417] Shorter statute against professionals
(6) [5:418] Repurchase offer no bar
d. [5:419.5] Statutory liability for market manipulation/deception
(1) [5:419.6] Who may sue
(a) [5:419.7] Reliance not necessary
(b) [5:419.8] Plaintiffs not limited to California purchasers/sellers
(c) [5:419.9] Limitation—federal preclusion (“preemption”) of state law class actions
(2) [5:419.10] Scope of recovery
(a) [5:419.10a] Applicability of federal standard for loss causation
(3) [5:419.11] Who may be held liable
(a) [5:419.11a] High level of scienter required
(b) [5:419.11b] Conduct prohibited
(c) [5:419.11c] Liability of brokerage and clearing firms under § 25400(b)
(4) [5:419.12] Contribution and indemnification among defendants
(5) [5:419.13] Two-year/five-year statute of limitations
e. [5:420] Compare—common law liability
(1) [5:421] Negligent misrepresentation
(a) [5:421a] Misrepresentation actionable where shareholder induced not to sell
1) [5:421b] Pleading reliance—specificity required
2) [5:421c] Compare—personal reliance not required in derivative action
3) [5:421d] Compare—Rule 10b-5 cause of action
(b) [5:421h] Misleading statements and “half-truths” actionable
(c) [5:421.1] Scienter not required
(d) [5:421.1a] Limitation—reliance not presumed (“fraud on the market” rejected)
(e) [5:421.2] Attorneys' and accountants' liability
1) [5:421.3] Professional “opinions” treated as facts
(f) [5:422] Compare—issuers' and sellers' statutory liability
(2) [5:423] Fraudulent misrepresentation
(a) [5:423.1] “Materiality”
(b) [5:423.3] “Knowledge of falsity” synonymous with “scienter”
1) [5:423.4] Example—suspicious stock sales in market manipulation case
(c) [5:423.5] Nondisclosure or incomplete disclosure actionable as fraud
(d) [5:423.6] Misrepresentation actionable where shareholder induced not to sell
(e) [5:423.7] Limitation—reliance not presumed (“fraud on the market” rejected)
(f) [5:423.8] Attorney liability
(g) [5:423.13] Conspirator liability
1) [5:423.13a] Compare—aiding and abetting
(h) [5:423.13b] Three-year statute of limitations
(i) [5:423.14] Scope of recovery
1) [5:423.15] Loss causation requirement
2) [5:423.25] Includes funds expended to mitigate damages

(j) [5:424] Compare—issuers' and sellers' statutory liability
(3) [5:425] Implied misrepresentation
(4) [5:425.5] Breach of fiduciary duty
(a) [5:425.5a] Statute of limitations
1) [5:425.5b] Compare—action against attorney
f. [5:425.10] No liability under Unfair Competition Law (Bus. & Prof.C. § 17200 et seq.)
(1) [5:425.11] Comment
g. [5:426] Administrative and civil proceedings by Financial Protection and Innovation Commissioner and Attorney General
(1) [5:427] Investigations
(a) [5:427.1] Subpoena power
(b) [5:427.2] Immunity from self-incrimination
(c) [5:427.3] Criminal penalties for falsification or concealment
(2) [5:428] Publishing findings
(3) [5:429] Order by Commissioner to halt unlawful acts
(4) [5:430] Civil proceeding seeking injunction and other remedies
(a) [5:430a] Injunction barring individual from serving as officer or director
(b) [5:430b] Ancillary monetary remedies
1) [5:430c] Broader liability than in private action
(c) [5:430.1] Civil penalties
(d) [5:430.2] Four-year limitations period
h. [5:431] Criminal sanctions
(1) [5:431a] Three-year limitations period
(2) [5:431b] Knowledge requirement for rule or order violation
(3) [5:431c] Jury must decide if a "security" exists
(4) Section 25401 misrepresentation
(a) [5:431.1] Scienter requirement
(b) [5:431.1a] Act must be willful
(c) [5:431.1b] Conspiracy liability
(d) [5:431.1c] Aider and abettor liability
(e) [5:431.1d] Mistake of law defense
(5) Offer or sale of unqualified security in violation of § 25110
(a) [5:431.2] Good faith belief in exemption as defense
(b) [5:431.3] Good faith belief that sale did not involve a security
i. [5:431.11] Good faith compliance with Commissioner's interpretive opinion as defense to liability
(1) [5:431.12] Form of request
(2) [5:431.13] Commissioner's discretion to issue opinion

[5:195] Any security that is offered or sold in California must comply with the Corporate Securities Law (Corps.C. § 25000 et seq.) in addition to federal law (unless *preempted*).

1. [5:195a] **Qualification Requirement—In General:** Unless state regulation is preempted by federal law (*¶ 5:18.5 ff.*), or a state exemption applies, no issuer may offer or sell its securities in California without first having qualified the issue with the Financial Protection and Innovation Commissioner. [Corps.C. § 25110]

a. [5:195.1] **Scope of California statute:** In general, the California Corporate Securities Law is similar in scope to the federal law (Securities Act of 1933), discussed above (¶ 5:16 ff.). But there are some important distinctions:

(1) [5:195.2] **Jurisdictional limitation:** California law applies only to offers or sales of securities "made in this State"—which means that the offer (to buy *or* sell a security) must originate here, or be accepted here, or, if *both* the seller and buyer reside in California, the securities are delivered here. [Corps.C. § 25008]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [5:195.2a] **Application:** A California corporation (and any "foreign" corporation) will only be subject to the law if the offer or sale takes place *in this state*, including any offer to sell its securities to (or soliciting an offer to buy its securities from) a California resident. Thus, offers and sales factually made *entirely outside California* are *not* subject to the Corporate Securities Law merely because the issuer is incorporated in or a resident of California. [Commr. Opns. 74/18C, 81/6C]

However, the parties cannot avoid California law by stipulating, *contrary to fact*, that the entire transaction occurred outside California (e.g., in Nevada), or that another state's law shall govern the transaction. [*Hall v. Sup.Ct. (Imperial Petroleum, Inc.)* (1983) 150 CA3d 411, 418-419, 197 CR 757, 762-763]

(b) [5:195.2b] **Caution—federal preemption:** The 1933 Act expressly *preempts* state qualification requirements for certain categories of securities and transactions (*see ¶ 5:18.5 ff.*). Whether a specific California exemption or procedure is so preempted is noted throughout this section.

(2) [5:195.3] **"Security":** The statutory definition of "security" is quite broad and similar to the federal law (*see ¶ 5:32 ff.*). It specifically includes any certificate of interest or participation in a profit-sharing agreement or venture, whether or not evidenced by any written document. [Corps.C. § 25019; see *People v. Black* (2017) 8 CA5th 889, 905, 214 CR3d 402, 416; *People v. Frederick* (2006) 142 CA4th 400, 413, 48 CR3d 585, 596-597]

It also includes LLC membership interests, *unless* all LLC members are actively engaged in managing the company (*¶ 5:41.1*). [Corps.C. § 25019]

(a) [5:195.3a] **"Risk capital" and "*Howey*" tests employed:** An investment may constitute a "security" under California law if it satisfies *either* the "risk capital" or "*Howey*" tests (*see ¶ 5:33 ff.*). [*People v. Black* (2017) 8 CA5th 889, 900, 214 CR3d 402, 411-412; *Moreland v. Department of Corporations* (1987) 194 CA3d 506, 512-513, 239 CR 558, 561-562 & fn. 3]

1) [5:195.3b] **Application of "risk capital" test:** Under the risk capital test, a "security" is involved if the investor has provided the risk capital for the enterprise, and persons other than the investor will be *primarily* responsible for managing the business (*see ¶ 5:37*). Thus, more than essentially passive investments are included—e.g., various franchise schemes, pyramid sales plans, and other "profit-sharing" arrangements may be securities under California law, even though the investor took some part in management of the business.

a) [5:195.3c] **Factors to consider:** In applying the risk capital test, California courts consider whether:

- The funds are raised for a business venture or enterprise;

- The transaction is offered "indiscriminately to the public at large";

- Investors are "substantially powerless" to affect the success of the venture (i.e., are passive); and

- Investors' money is "substantially at risk" because unsecured (or inadequately secured). [*Moreland v. Department of Corporations* (1987) 194 CA3d 506, 519, 239 CR 558, 566; *People ex rel. Bender v. Wind River Mining Project* (1990) 219 CA3d 1390, 1400-1401, 269 CR 106, 112-113]

(b) [5:195.3d] **Jury must decide if a "security" exists in criminal cases:** *See discussion at ¶ 5:431c.*

(3) [5:195.4] **"Sale" or "offer to sell":** Under California law, "sale" or "offer to sell" a security is similar to the federal definitions (*¶ 5:26 ff.*).

(a) [5:195.4a] **Caution—includes changes in shareholder rights:** However, under California law, a "sale" or "offer to sell" also includes any change in the *rights, preferences, privileges or restrictions* of outstanding securities (e.g., as a result of changes in the capital structure). [Corps.C. § 25017(a); *see ¶ 5:31*]

(b) [5:195.4b] **Limitation—community property division not a "sale":** A transfer of securities between spouses as part of a marriage dissolution property settlement is *not* a "sale" for California securities law purposes. Marital dissolution has its own complex set of property valuation and division rules and procedures. The addition of securities remedies is unnecessary and would make "a process which is already too complicated even more expensive." [*d'Elia v. d'Elia* (1997) 58 CA4th 415, 425-432, 68 CR2d 324, 331-335—no securities fraud claim against husband who misrepresented value of closely held business and induced wife to forego appraisal]

(4) [5:195.5] **Exempt securities:** In general, the particular kinds of securities exempt from the 1933 Act registration requirements (e.g., securities issued by any federal, state or other public agency, or by banks, savings and loans, or other financial institutions regulated by public agencies, or by charitable institutions, etc.; *see ¶ 5:42*) are excluded from the qualification requirements of California law. This exclusion is based upon two independent grounds:

- The 1933 Act expressly *preempts* state laws that could otherwise require qualification of many of these exempted securities. [SA § 18(a), (b)(4)(E) (15 USC § 77r(a), (b)(4)(E)); *see ¶ 5:18.5 ff.*]

- The Corporate Securities Law expressly *exempts* these securities from qualification. [See Corps.C. § 25100]

(a) Other exempt and/or "preempted" securities

1) [5:195.5a] **Secured promissory notes:** The Corporate Securities Law expressly exempts a promissory note secured by a lien on real property. (But a note in which *fractional* interests are sold, or one of a series of notes secured by the *same* property, is *not* exempt … although a *sale* of such a note may fall within a *transactional* exemption, most notably the § 25102.5 exemption for certain sales through licensed real estate brokers, *discussed at ¶ 5:223.15*.) [Corps.C. § 25100(p) (*discussed at* ¶ 5:223.11 ff.); *People v. Schock* (1984) 152 CA3d 379, 390, 199 CR 327, 333; *People v. Miller* (1987) 192 CA3d 1505, 1511, 238 CR 168, 171]

2) [5:195.5b] **Securities of "listed" corporations:** The Corporate Securities Law conforms to the 1933 Act preemption provisions (*see ¶ 5:18.6*) by expressly exempting securities listed (or authorized for listing) on a national securities exchange certified by the Financial Protection and Innovation Commissioner. Also exempted are securities (including debt instruments) equal or senior to these securities. [Corps.C. §§ 25100(o), 25100.1(a), 25101(a); see SA § 18(a), (b)(1) (15 USC § 77r(a), (b)(1))]

The national securities exchanges certified by the Commissioner are:

— New York Stock Exchange,

— NYSE Amex (now NYSE American),

— Nasdaq Global Select Market,

— Nasdaq Global Market,

— Nasdaq Capital Market,

— Tier 1 of NYSE Arca, and

— Tier 1 of NASDAQ OMX PHLX (now known as Nasdaq PHLX). [Commr. Rule 260.101.2; Commr.Rel.No. 88-C (revised 2009); Commr.Rel.No. 87-C (revised 2009)]

3) [5:195.5c] **Investment company securities:** Again in conformity to the 1933 Act preemption provisions (*see ¶ 5:18.7 ff.*), California exempts securities issued by an investment company that (i) is registered (or that has filed a registration statement) under the Investment Company Act of 1940 and (ii) has filed certain documents and paid a filing fee to the Financial Protection and Innovation Commissioner prior to any offer or sale in California. [Corps.C. § 25100.1(b); see SA § 18(a), (b)(2), (c)(2), (3) (15 USC § 77r(a), (b)(2), (c)(2), (3))]

4) [5:195.5d] **Compare—exempted/"preempted"** ***transactions:*** *See ¶ 5:200 ff.*

(b) [5:195.6] **Antifraud rules still apply:** Even if a security is exempted or "preempted" from the *qualification* requirements of California law, the general antifraud and civil liability provisions still apply (*see ¶ 5:390 ff.*).

b. [5:196] **Qualification compared to federal registration:** "Qualification" is the process by which an issuer seeks authority to sell and issue its securities in California. The procedure is roughly similar to the *registration* procedure under the federal securities law, *described at ¶ 5:45 ff.* But the concept is different in that the federal registration requirements are designed simply to compel *disclosure* of all material facts. Qualification, on the other hand, is more paternalistic. It requires obtaining

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

authority from a state officer (Financial Protection and Innovation Commissioner) for the securities transaction based on standards of fairness—i.e., a review on the merits.

c. Methods of qualification

(1) [5:197] **Qualification by permit:** The most common method of qualifying securities for closely-held corporations is to obtain a *permit* from the Financial Protection and Innovation Commissioner, authorizing the corporation to sell a specified amount of securities within a specified period of time. [Corps.C. § 25113]

A permit is not automatically granted, however. The Commissioner may refuse it unless they find that the issuance would be "fair, just and equitable" and would not "work a fraud" on the purchasers. [Corps.C. § 25140(b); ¶ *5:317*]

(a) [5:197.1] **Procedure:** *See detailed discussion at ¶ 5:315 ff.*

(2) [5:198] **Qualification by notification:** Shares not registered under federal law, but which are to be issued by an issuer that has outstanding securities registered under the 1934 Act (an "SEC reporting company"), can be qualified for sale in California by a simplified procedure. Basically, the issuer is allowed to incorporate much of the information already furnished to the SEC. [Corps.C. § 25112]

(a) [5:198.1] **Exemption for listed securities:** The Corporate Securities Law conforms to the preemption provisions of the 1933 Act (*see* ¶ *5:18.6*) by exempting from all qualification requirements (including qualification by notification) securities listed (or authorized for listing) on a national securities exchange certified by the Financial Protection and Innovation Commissioner. Also exempted are securities (including debt instruments) equal or senior to these securities. [Corps.C. § 25100(o); see SA § 18(a), (b)(1) (15 USC § 77r(a), (b)(1))]

The national securities exchanges certified by the Commissioner are set forth at ¶ *5:195.5b*.

(b) [5:198.2] **Note re investment company securities:** The § 25112 notification procedure is expressly applicable to securities issued by a company registered under the Investment Company Act. [See Corps.C. § 25112] However, such securities are, in conformity to the 1933 Act preemption provisions (*see* ¶ *5:18.7 ff.*), exempt from qualification … *except* for certain notice filing and fee requirements which must be met prior to any offer or sale in California. [Corps.C. § 25100.1(b); see SA § 18(a), (b)(2), (c)(2), (3)(15 USC § 77r(a), (b)(2), (c)(2), (c)(3))]

Thus, investment companies are subject to something of a "streamlined" notification process.

(c) [5:198.3] **Commissioner's authority to refuse, suspend or revoke qualification:** *See ¶ 5:199.1 ff.*

(3) [5:199] **Qualification by coordination:** Shares being *registered* under the federal Securities Act of 1933, including shares offered under the Regulation A "short form" registration (¶ *5:190 ff.*), can be qualified for sale in California simply by furnishing copies of the federal registration statement and other information furnished to the SEC. [Corps.C. § 25111]

(a) [5:199.1] **Commissioner's authority to refuse, suspend or revoke qualification:** The Commissioner has discretion to issue stop orders denying effectiveness to, or suspending or revoking, any qualification by coordination (or notification, ¶ *5:198*). [Corps.C. § 25140]

1) [5:199.2] **Underwritten offerings:** An underwritten offering may be prevented *only if* the Commissioner determines:

• Issuance of a stop order is in the public interest; *and*

• The issuer's proposed business plan or the proposed issuance or sale of securities is *not* fair, just or equitable, *or* the issuer does not intend to transact business fairly and honestly, *or* the securities or the method to be used in issuing them will tend to work a fraud upon the purchasers. (But the Commissioner cannot block the offering on the basis that the *price* is unfair if the offering is solely for cash and *firmly underwritten* by registered broker-dealers.) [Corps.C. § 25140(a)(1) & (d)]

2) [5:199.3] **Offerings not underwritten:** On the other hand, an offering that is not underwritten may be prevented *unless* the Commissioner determines:

• Issuance of a stop order is *not* in the public interest; *and*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The issuer's business plan or the issuance or sale of securities is fair, just and equitable, the issuer intends to transact business fairly and honestly, *and* the securities or the method to be used in issuing them will *not* work a fraud upon the purchasers. [Corps.C. § 25140(a)(2)]

(4) [5:199.4] **Comment:** Securities eligible for qualification by notification or coordination could also be qualified by permit (Corps.C. § 25113(a)). However, it would be unusual to seek a permit (involving more extensive review) where the more streamlined notification or coordination methods are available.

2. [5:200] **Exemptions From Qualification:** As with the federal registration requirements, qualification is expensive, time consuming and burdensome. Moreover, there is the additional concern in California that the Financial Protection and Innovation Commissioner might exercise their discretion to *refuse, prevent, suspend or revoke* qualification (see ¶ 5:196 ff.).

Therefore, counsel's goal usually is to structure the issuance of securities so that it fits within one or more of the statutory exemptions provided in the Corporate Securities Law. The most important of these exemptions are discussed below (¶ 5:201).

• ***CHART:*** See *Summary Comparison of Major Federal and State Exemptions following ¶ 5:80*.

a. [5:201] **Exemption for "private" offers and subscriptions (NOT sales):** An offer or agreement for sale of securities (but *not* the actual sale or issuance) is exempt from qualification, if the transaction "does not involve a public offering." [Corps.C. § 25102(a)]

(1) [5:202] **Application:** This exemption is intended to cover the negotiation process whereby agreements are reached for the issuance of shares among a small group of persons. The typical example is a *pre-incorporation subscription agreement* (*¶ 3:380*).

The offer or subscription may apply to any type of security (shares, partnership interests, debt, etc.). And, there is no limit on the amount of securities covered by such offers or subscriptions.

(2) [5:203] **Offering "nonpublic" if limited to 35 persons:** For purposes of this exemption, an offering is treated as "nonpublic" if made to not more than 35 "counted" persons (see ¶ 5:204 ff.). [Commr. Rule 260.102.1]

(a) [5:204] **Computation of 35-person limit:** Spouses (acting for themselves or for their minor children) are counted as a single purchaser. Moreover, offerings to officers, directors or affiliates of the issuer, and certain others designated in Rule 260.102.13 are not counted as part of the 35-purchaser limit (similar to "accredited" investors under Regulation D, ¶ 5:174 ff.).

(b) [5:205] **Compare—offerings to more than 35 persons:** Simply because an offering is made to more than 35 persons does not necessarily make it a "public" offering. Rather, the determination of whether it is "public" or "private" is made on a case-by-case basis without reference to the 35-person limitation in the Commissioner's Rule. [Commr. Rule 260.102.1]

➪ [5:206] ***PRACTICE POINTER:*** Even so, the Rule provides a convenient "safe harbor." Therefore, you should advise your clients to confine their solicitations and subscriptions to no more than 35 persons wherever possible.

1) [5:207] **Negotiation permit required for "public" offers:** Offerings that do not qualify as "private," and are not otherwise exempt, may not be made prior to qualification unless a negotiating permit is obtained from the Financial Protection and Innovation Commissioner. [Corps.C. § 25102(c); Commr. Rule 260.102]

(3) [5:208] **Subscription agreements must be conditioned on qualification:** The exemption for nonpublic offerings requires that if an agreement for sale of securities (i.e., subscription; *¶ 5:287.2*) is to be executed, it *must* contain substantially the following provision:

> "The sale of the securities that are the subject of this agreement has not been qualified with the Commissioner of [the Department of Financial Protection and Innovation] of the State of California and the issuance of the securities or the payment or receipt of any part of the consideration therefor prior to the qualification is unlawful, unless the sale of securities is exempt from the qualification by Section 25100, 25102, or 25105 of the California Corporations Code. The rights of all parties to this agreement are *expressly* conditioned upon the qualification being obtained, unless the sale is so exempt." [Corps.C. § 25102(a) (emphasis added)]

➪ [5:209] ***PRACTICE POINTER:*** Of course, qualification will be required only if the issue is *otherwise* nonexempt. In view of the broad reach of the Corps.C. § 25102(f) and (h) exemptions (discussed below; ¶ 5:224 ff., 5:256 ff.), most issuances by small closely-held corporations are exempt. In such cases, where both the offer *and* sale are otherwise exempt, the above language (¶ 5:208) is *not* required in the subscription agreement (*see* ¶ *3:392*).

(4) [5:210] **No disclosure requirement:** The California exemption does not specifically require that the issuer furnish the offeree information of any kind in connection with the offer or agreement for sale. [See Corps.C. § 25102(a)]

(a) [5:211] **Compare—federal exemptions:** If the corporation intends to rely on the Rule 506 "private placement" exemption, there are specific disclosure requirements for offerings to ordinary ("non-accredited") investors. [See SEC Rule 506 (17 CFR § 230.506), ¶ *5:182*]

On the other hand, the corporation may be able to avoid specific disclosure requirements by utilizing some other federal exemption: E.g., there is *no* specific disclosure requirement under the SEC Rule 504 "small offerings" exemption (¶ 5:119); nor under the SEC Rule 147 and SEC Rule 147A "intrastate offering" exemption (¶ 5:81).

➪ [5:212] ***PRACTICE POINTER:*** Even if the state and federal exemptions do not specifically require disclosure, it is important to prepare a disclosure document (e.g., offering memorandum)—particularly where the shares are being offered to persons who are expected to be "passive" investors, or who are not intimately acquainted with the organizers and the business venture. Such a memorandum manifests a business-like approach for the corporation, and may protect against later claims of "fraud" or "concealment" by disgruntled investors. (*See* ¶ *5:120*.)

[5:212.1 - 5:212.4] ***Reserved.***

b. [5:212.5] **Exemption for Internet offerings (*not sales):*** An offer (but *not* a sale) made on or through the Internet is exempt from qualification if:

• The offer originates *outside* California, is not directed to any person in California, and indicates the securities are not being offered or sold to California residents; *and*

• No sales will be made in California as a result of the Internet offering without prior qualification and delivery of a disclosure document to each California purchaser (unless the security or sale is otherwise exempt from qualification). [Commr.Rel.No. 100-C (1996)]

(1) [5:212.6] **Federal preemption re crowdfunding offerings:** Offers *and sales* made in reliance upon the federal crowdfunding exemption (SA § 4(a)(6); Reg. Crowdfunding Rule 100 et seq.; ¶ *5:106 ff.*) are not subject to state law qualification requirements (other than notice filings). [SA § 18(a)(1)(A), (b)(4)(C), (c)(2)(F) (15 USC § 77r(a)(1)(A), (b)(4)(C), (c)(2)(F)); *see* ¶ *5:106.32*]

[5:212.7 - 5:212.9] ***Reserved.***

c. [5:212.10] **Exemption for offerings filed with SEC:** Offers (but not sales) of securities for which a 1933 Act registration statement (¶ *5:54 ff.*) or Reg. A offering statement (¶ *5:192 ff.*) has been *filed* are also exempt from qualification. [Corps.C. § 25102(b)]

d. [5:213] **Exemption for "private" sales of debt securities:** The offer *or sale* of debt securities is exempt from qualification if no public offering is involved. [Corps.C. § 25102(e)]

This exemption covers not only the offering, but also the *sale and issuance* of the securities themselves (unlike the Corps.C. § 25102(a) exemption, ¶ 5:201 ff.).

(Similar exemptions exist for notes secured by *real property*; *see* ¶ *5:223.11 ff.*)

(1) [5:214] **Applies only to debt securities:** The § 25102(e) exemption applies only to debt securities: e.g., promissory notes, bonds, debentures or any other evidence of indebtedness, whether secured or unsecured, and to any guarantees thereof. [Corps.C. § 25102(e)]

(a) [5:215] **Not convertible debt:** The Corps.C. § 25102(e) exemption does *not* apply to common or preferred stock or to debt instruments *convertible* into such stock … *unless* such stock would be exempt from qualification under some exemption *other than* Corps.C. § 25102(h). [Commr. Rule 260.102.3]

1) [5:216] **Comment:** Of course, a far *broader* exemption is now available under Corps.C. § 25102(f), covering such kinds of securities and effectively superseding this exemption. *See* *¶ 5:256*.

(2) [5:217] **"Nonpublic" transactions:** An offering or sale of debt securities is *presumptively* private (i.e., no "public" offering) if:

(a) [5:218] **Limited to 25 offerees:** The debt securities are *offered* to not more than 25 persons—unlike the 35-purchaser ceiling for the Corps.C. § 25102(a), (f) and (h) exemptions; and

(b) [5:219] **Limited to 10 purchasers:** Actual *sales* are made to not more than 10 of such offerees; and

(c) [5:220] **Offeree qualifications:** *All* of the offerees have *either* a pre-existing personal or business relationship with the issuer's officers, directors or controlling persons; *or* sufficient business or financial experience to be reasonably assumed to have the capacity to protect their own interests. [Commr. Rule 260.102.2]

(d) [5:221] **Computation of 25 and 10 person limits:** For purposes of the limitations on numbers of offerees (25) and purchasers (10), spouses (whether acting for themselves or their minor children) are counted as one person. And, banks and other institutional investors are excluded. [Commr. Rule 260.102.2]

(e) [5:222] **Compare—offerings or sales to more persons:** The 25 and 10 person limits contained in the Commissioner's rule are *not* exclusive; and the Rule does not create any presumption that offerings or sales to a greater number of persons are necessarily "public" offerings. [Commr. Rule 260.102.2]

➪ [5:223] ***PRACTICE POINTER:*** As a practical matter, the broader exemption under Corps.C. § 25102(f) can now be utilized to exempt up to *35* "counted" purchasers, with *no limit* on the number of offerees (*see* *¶ 5:261*). Therefore, there is usually no reason to utilize the more restrictive exemption available under Corps.C. § 25102(e).

In the rare case where the § 25102(e) exemption is still relied upon, it may be difficult to establish the "private" character of such offering outside the 25/10 rule (¶ 5:217 ff.). Therefore, if you intend to rely on this exemption, be sure to advise clients to confine their offerings or sales of debt securities to these limits.

[5:223.1 - 5:223.4] ***Reserved.***

(f) [5:223.5] **Filing requirement in offerings by realty-related issuers:** An issuer *engaged in the business of purchasing, selling, financing or brokering real estate* that makes an offer or sale of *debt* securities in reliance on the Corps.C. § 25102(e) exemption—*or* an offer or sale of *any security* (e.g., its common stock) in reliance on any of the transactional exemptions contained in Corps.C. §§ 25102(f) (*¶ 5:256 ff.*), 25012(h) (*¶ 5:224 ff.*) or 25102(n) (¶ 5:304.6 ff.)—must file a notice with the Financial Protection and Innovation Commissioner if an offer or sale is made to any person who is not an "accredited" investor (as defined in Reg. D, ¶ 5:174 ff.). [Corps.C. § 25102.2; Commr.Rel.No. 121-C (2012)]

1) [5:223.6] **Contents of notice:** The notice must include:

- The names of the issuer's officers and directors;
- A copy of the disclosure document provided by the issuer to prospective purchasers;
- A list of all state and federal licenses required to further the purposes of the investment; and
- The names of all licensed persons who will undertake those activities. [Corps.C. § 25102.2; Commr.Rel.No. 121-C (2012)]

FORM: The Commissioner's form notice, Real Estate Related Information Required Pursuant to Corporations Code Section 25102.2 (Form DBO-SB 978, also known as Form 25102.2), is available online at the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

2) [5:223.7] **Where to file notice:** The notice may be filed in person or by mail at any office of the Department of Financial Protection and Innovation's Division of Corporations. [Commr.Rel.No. 121-C (2012)]

The notice may also be filed online at the Department's Self Service Portal (*https://docqnet.dfpi.ca.gov*).

3) [5:223.8] **No filing fee:** There is no fee for filing the notice.

[5:223.9 - 5:223.10] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(3) [5:223.11] **Compare—exemption for notes secured by realty:** There is an exemption from qualification for *notes* secured by real property. [Corps.C. § 25100(p)]

However, the exemption is not as broad as it may at first appear.

(a) [5:223.12] **Limitations imposed by Business and Professions Code:** An offer or sale of a note secured by an interest in real property, or the offer or sale of an *undivided interest* in such a note, is subject to various limitations under the Business and Professions Code, including purchaser qualifications and restrictions and conditions relating to appraisals and encumbrances on the property. [See Bus. & Prof.C. § 10232.3; see also Bus. & Prof.C. §§ 10232, 10232.45 (applicable to real estate brokers)]

[5:223.13 - 5:223.14] ***Reserved.***

(4) [5:223.15] **Compare—exemption for limited** ***sales by real estate brokers of realty-secured notes:*** Also exempt from qualification are *sales* of a series of notes secured by the same real property, or undivided interests in the same note secured by real property, to not more than 10 qualified investors (plus an unlimited number of institutional investors), provided the sales are made by or through a licensed real estate broker and certain other requirements are met. [See Corps.C. § 25102.5; Bus. & Prof.C. § 10237 et seq.]

e. [5:224] **Exemption for closely-held corporations (§ 25102(h)):** The offer or sale of common stock in a closely-held corporation is exempt from qualification if all of the requirements below are met (¶ 5:225 ff.). There is *no dollar limit* on the amount of securities that may be issued under this exemption. [Corps.C. § 25102(h)]

(1) [5:225] **Only one class of shares outstanding:** The exemption is available only for *voting common stock*, and only if upon issuance there will be *no other class* of stock outstanding. [Corps.C. § 25102(h)]

(a) [5:226] **Debt securities not stock:** Debt securities will *not* be treated as a second class of stock, so as to defeat the exemption—even if they are determined to be "equity" for income tax purposes (*see ¶ 3:41*), or for the purpose of determining priorities among creditors in bankruptcy or insolvency proceedings. [Commr. Rule 260.102.4(a)]

(b) [5:227] **Shares subject to restrictions:** However, a shareholders agreement limiting or restricting voting rights, or otherwise modifying any of the rights, preferences or privileges of *some* of the outstanding shares, *will be treated as creating a second class of shares*—destroying the exemption. [Commr. Rule 260.102.4(b)]

1) [5:228] **Impact on statutory close corporations:** Thus, the usual type of shareholders agreement utilized by a *statutory close corporation* to allocate management and control (*see ¶ 3:262*) may make the Corps.C. § 25102(h) exemption unavailable.

This could be a factor to consider in deciding upon close corporation status. (But the broader exemption under Corps.C. § 25102(f) (¶ 5:256 ff.) is usually available for close corporations in any event.)

(2) [5:229] **No more than 35 beneficial owners:** There may be no more than 35 persons who are the beneficial owners of the voting common stock issued pursuant to this exemption. [Corps.C. § 25102(h)]

(a) Computation of 35-person limit

- [5:230] Shares held by spouses, whether or not held jointly, are considered as held by one person. [Corps.C. § 25102(h)(5)]
- [5:231] Shares held by a *partnership* or joint venture are considered owned beneficially by each partner or joint venturer. [Commr. Rule 260.102.5(a)]
- [5:232] Similarly, shares held by a *trustee* are considered owned beneficially by each of the beneficiaries … including future and contingent beneficiaries in certain cases. [See Commr. Rule 260.102.5(a)]
- [5:233] Shares held by a *corporation* are considered held by one person *except* if the corporate shareholder has itself issued securities pursuant to this exemption … in which case, the shares it holds are considered to be owned by its shareholders (so that if it has more than 35 shareholders, the exemption is lost). [Corps.C. § 25102(h)(5)]

(3) Consideration for which shares issued

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [5:234] **If shares issued to only one person:** There is no limit on the type of consideration for which shares may be issued under this exemption where there will be only one owner of the corporation's shares after issuance. Any legal consideration suffices. [Corps.C. § 25102(h)(2)(D)]

(b) [5:235] **If shares issued to more than one person:** If shares are to be issued to more than one person, then the exemption is available only if the shares are being issued for the following types of consideration:

- [5:236] On initial capitalization of the corporation, shares may be issued either for *cash* or *cancellation of debt for money borrowed* (cancellation of debt for goods or services does *not* qualify) … provided all such shares are issued at the same price. [Corps.C. § 25102(h)(2)(B)]
- [5:237] Alternatively, on initial capitalization of the corporation, shares may be issued in exchange for the *assets of an existing business* (which may include cash) … provided the business has been in operation for at least one year, and the shares are issued to the owners of the business in proportion to their ownership interests in the business. [See Corps.C. § 25102(h)(2)(A)]
- [5:238] *After the original issuance*, further shares may be issued *only for cash*, and then only if the sale is to existing shareholders and is approved *in writing* by all the other shareholders. [Corps.C. § 25102(h)(2)(C)]
- [5:239] *No promotional consideration* may be given or paid to anyone in connection with the share issuance. This includes shares, debt instruments or anything else of value paid (directly or indirectly) to any of the organizers for services rendered in connection with founding the corporation. [Corps.C. § 25102(h)(3)]

(4) Restrictions on manner of sale

(a) [5:240] **No general solicitation:** As in the case of most Reg. D offerings (¶ 5:121, 5:173), the offer and sale of securities under Corps.C. § 25102(h) must not be accompanied by any advertising or general solicitation. [Corps.C. § 25102(h)(1)]

(b) [5:241] **No selling expenses:** Nor may any selling expenses be paid or incurred in connection therewith. (This includes commissions or discounts or other compensation paid as remuneration to any person for selling the securities.) [Corps.C. § 25102(h)(1); Commr. Rule 260.102.7]

(Compare: In contrast, Reg. D and Corps.C. § 25102(f) exemptions permit selling expenses; *see* ¶ *5:122 and 5:301*.)

(5) [5:242] **Purchaser representations (resale restrictions):** *Each* purchaser must represent to the issuer that they are purchasing for their own account (or a trust account if the purchaser is a trustee) and *not* with a view to or for sale in connection with any *distribution* of the shares. [Corps.C. § 25102(h)(5)]

(a) [5:242.1] ***Written representations recommended:*** Though not required by the statute, purchaser representations should be made *in writing*. As a practical matter, no issuer could rely on oral representations.

1) [5:242.2] **Investment letter:** The written representations may be obtained by requiring the purchaser to sign an investment letter.

- ***FORM:*** Investment Representations Letter, *see Form 5:A*.

2) [5:242.3] **Subscription agreement:** Subscription agreements (i.e., contracts to purchase corporate stock) may also contain the requisite representations. If such an agreement is used, an investment letter is unnecessary.

- ***FORM:*** Subscription Agreement, *see Form 5:B.*

(b) [5:242.4] **No specific holding period:** The purchaser's intent *at the time of purchase* is the important factor. The fact that circumstances change, and the purchaser decides to sell the shares earlier than anticipated, does not retroactively defeat the exemption. No specific holding period (as under federal SEC Rules 144, 147 or 147A) is imposed.

(c) [5:242.5] **Intent not to sell in any "distribution":** The purchaser must represent that they are *not* purchasing with intent to engage in any "distribution" of the shares (*¶ 5:242*).

The meaning of the term "distribution" is not entirely clear, and is not defined in the Commissioner's rules. However, it undoubtedly includes any *planned resale* (i.e., purchase with an existing intent to resell) that would have violated the rules had it been part of the original sale, such as a sale to more than 35 purchasers (*see ¶ 5:229 ff.*).

(d) [5:242.6] **Prior law resale restriction and legend condition removed:** Prior to May 6, 1996, shares issued under the § 25102(h) exemption could not be sold or otherwise transferred without the Commissioner's consent (unless transferred

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

under one of the specific exemptions from the consent requirement). Additionally, a prescribed legend generally advising of these transfer restrictions had to be displayed on the face of the share certificates. [Former Corps.C. § 25102(h)(1); former Commr. Rule 260.141.1, 260.141.11(a), 260.141.12]

Shares issued under § 25102(h) are no longer subject to either the transfer restriction or legend requirement, and the legend may be removed from the certificates. [Corps.C. § 25102(h), last para.]

(6) [5:243] **Available to SPCs:** Nothing in the Social Purpose Corporations Act (Corps.C. § 2500 et seq., ¶ 9:3) modifies Corps.C. § 25102(h) or its conditions to availability of the exemption. [Corps.C. § 2502.07]

(7) [5:244] **Notice to Department of Financial Protection and Innovation Commissioner:** Finally, the exemption requires filing with the Financial Protection and Innovation Commissioner a notice of the share issuance. The form for the notice is prescribed by the Commissioner. [Corps.C. § 25102(h)(4); Commr. Rule 260.102.8]

FORM: The Commissioner's form, Notice of Share Issuance Pursuant to Corporations Code Section 25102(h) (Form DBO-260.102.8(a)), may be filled in and downloaded from the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

(a) [5:245] **Contents:** The notice form requires identifying information regarding the issuer and issuees, and representations by the issuer as to compliance with the exemption requirements (¶ 5:224 ff.).

(b) [5:246] **Consent to service:** In the case of a non-California corporation, it also requires appointment of the Financial Protection and Innovation Commissioner as the issuer's agent for service of process in any civil litigation arising under the Corporate Securities Law relating to the share issuance. [Corps.C. §§ 25102(h)(4), 25165]

• ***FORM:*** The Commissioner's standard form Consent to Service of Process (Form 260.165) may be filled in and downloaded from the Department of Financial Protection and Innovation's website (*www.dfpi.ca.gov*).

(c) [5:247] **Attorney opinion required:** The notice form includes an opinion to be signed by a member of the State Bar that the Corps.C. § 25102(h) exemption is available for the share issuance.

➪ [5:248] ***PRACTICE POINTER:*** Be sure that the facts support your opinion. Often, you will not have access to all the information required to qualify the issuance under Corps.C. § 25102(h). (For example, you may not know whether the named issuees are really the "beneficial owners" of the shares; or whether the corporation is paying anyone for raising capital; or whether there are agreements among the shareholders that might be construed to create a second class of shares.)

The Notice of Share Issuance (*see ¶ 5:244*) states that it is based on the facts stated in the Notice *as well as other information obtained by counsel*. It may be prudent for counsel to obtain a "backup" certificate from one or more duly authorized officers of the company (e.g., its CEO and CFO) and by the stock purchasers attesting to the predicate facts for counsel's opinion.

If you have reason to question the accuracy of any representations made by the corporate officers or stock purchasers, you should insist upon other verifying data or documentation *before* signing your opinion that the issue qualifies under § 25102(h).

(d) Filing requirements

1) [5:249] **Time:** The notice form should be filed with (or mailed to) the Financial Protection and Innovation Commissioner *within 10 business days* after receipt of the consideration for the shares. [Corps.C. § 25102(h)(4)]

a) [5:250] **Exception:** But where shares are issued in repayment of *advances for organizational expenses*, it is sufficient if the notice is filed within 10 days after the shares are issued. (The funds advanced are *not* deemed to be the "receipt of consideration" for the shares.) [Commr. Rule 260.102.11]

b) [5:250.1] **Otherwise, within 15 days after demand or discovery of failure to file:** If the issuer fails to file the notice within the required time, the issuer must, within 15 business days after demand by the Commissioner or discovery of such failure, *whichever occurs first*, file the notice *and pay a higher "penalty" fee* (*¶ 5:251.1*). [Corps.C. § 25102(h)(4)]

2) [5:251] **Fee:** The notice form must be accompanied by a filing fee, calculated as follows (Corps.C. § 25608(c)):

Value of Securities	*Filing Fee*

Proposed to Be Sold	
$25,000 or less	$ 25
$25,001 to $100,000	$ 35
$100,001 to $500,000	$ 50
$500,001 to $1,000,000	$150
Over $1,000,000	$300

a) [5:251.1] **Late filing penalty:** However, if the notice is filed late (*see ¶ 5:249 ff.*), the issuer must pay a higher fee—as if applying for qualification of the shares (based on the value of the securities, ranging from a minimum fee of $200 plus .2% of the aggregate value to a maximum fee of $2,500). [Corps.C. §§ 25102(h)(4), 25608(e)]

3) [5:252] **Mailing:** The notice form is to be mailed to the Financial Protection and Innovation Commissioner. An affidavit of such mailing should be prepared by the attorney, but it need not be filed with the Commissioner; it should be retained in duplicate in the records of the attorney and the issuer. [Commr. Rule 260.102.9]

(e) [5:253] **Failure to file does *not destroy exemption:*** Failure to file the notice, or to file same within the required time limits, does not affect availability of the exemption. The only consequence of failure to file is a *fee penalty* (¶ 5:251.1). This is the same as under the Corps.C. § 25102(f) exemption (*¶ 5:295*).

➪ [5:253.1] ***PRACTICE POINTER:*** Even so, it is sound practice to file the notice. Doing so fulfills the requirements of the exemption and also avoids the possibility of a fee penalty.

(f) [5:254] **Additional notice required for realty-related issuers:** A corporate issuer engaged in the business of *purchasing, selling, financing or brokering real estate* who offers or sells common stock in reliance on the Corps.C. § 25102(h) exemption must file a notice with the Financial Protection and Innovation Commissioner if an offer or sale is made to any person who is not an "accredited" investor (as defined in Reg. D, ¶ 5:174 ff.). The notice must be filed together with, and within the time specified for, the § 25102(h) Notice (¶ 5:244 ff.). [Corps.C. § 25102.2; Commr.Rel.No. 121-C (2012); *see further discussion at ¶ 5:223.5 ff.*]

(8) Comment—"pros and cons" of § 25102(h) exemption

(a) [5:255] **Disadvantages:** The Corps.C. § 25102(h) exemption clearly has several disadvantages that may make it unworkable for many small business corporations. The prohibition against promotional consideration (e.g., for services) renders the exemption unavailable if stock options are being granted to key employees. Further, the one-class-of-voting-shares limitation makes it dangerous for the shareholders to enter into *any* sort of agreement affecting management or financial matters if the agreement could *possibly* be construed to give certain shareholders better status than others.

Equally important, the exemption cannot be utilized where the corporation is receiving "mixed" consideration for the shares—e.g., where one of the founding shareholders wishes to contribute cash, and others wish to receive shares for services rendered or for *property* other than cash.

(b) [5:255.1] **Advantage:** On the other hand, these disadvantages could be outweighed in many cases by the one important advantage Corps.C. § 25102(h) affords over the Corps.C. § 25102(f) exemption: Purchasers need not be qualified (*¶ 5:277 ff.*); i.e., the issuer can sell to anyone, provided there is no "general solicitation."

f. [5:256] **Limited offering exemption (§ 25102(f))—"utility infielder" exemption:** Section 25102(f) exempts sales to up to 35 purchasers (excluding certain persons), provided they each have a pre-existing relationship with the issuer or the ability to protect their interests in the transaction. There is *no dollar limitation* and *no specific disclosure requirement* under this exemption. [Corps.C. § 25102(f)]

(As will be seen, the requirements under this exemption are similar in some respect to the requirements under federal *Regulation D* exemptions, *discussed at ¶ 5:107 ff.*)

(1) [5:257] **"Offer or sale":** The exemption covers both the negotiations for sale and the actual sale and issuance of the securities. It is thus considerably broader than the Corps.C. § 25102(a) exemption, which does not extend to actual sales (*see ¶ 5:201*).

(a) [5:258] **Exception—issuer's own retirement plan:** But offers or sales to a pension or profit-sharing trust of the issuer do *not* qualify under this exemption. (Such issuances usually must be qualified with the Financial Protection and Innovation Commissioner to protect employee interests therein.) [Corps.C. § 25102(f)]

(b) [5:259] **Exercise of stock options, etc.:** Shares issuable by exercise of stock options or warrants or conversion rights in other securities, are deemed "offered" or "sold" *when the options, warrants or convertible securities are granted or issued* … rather than later when they are exercised. [Corps.C. § 25017(e)]

(2) [5:260] **"Any security":** The exemption covers any security subject to the Corporate Securities Law—shares, debt securities, *investment contracts*, certain partnership interests, etc. (*See ¶ 5:195.3*.)

(3) [5:261] **"Not more than 35 purchasers":** The exemption is available if *sales* of the security are made to not more than 35 "counted" purchasers, including persons outside California. (Note that the number of offerees is not counted; it is the number of *purchasers* only.) [Corps.C. § 25102(f)(1); Commr. Rule 260.102.12(d)(2)]

(a) Computing the 35-person limit

1) [5:262] **Family purchases count as one:** Spouses count as a single purchaser, whether their shares are held jointly *or* separately. Moreover, if additional shares are purchased by either spouse's *relatives* residing with them, or by a trustee or custodian acting for their minor children, all are still counted as a *single* purchaser. [Corps.C. § 25102(f)(4);Commr. Rule 260.102.13(c)(1)]

2) [5:263] **Controlled entities:** Similarly, a corporation, partnership or other entity purchasing shares is not counted separately if it is more than 50% owned by someone who has already been counted as a purchaser (whether such ownership is alone or in combination with spouse or trustee or custodian of minor children). [Commr. Rule 260.102.13(c)(2), (3)]

3) [5:264] **Other entities:** A corporation, partnership or other entity buying shares is counted as a single purchaser … *unless* it was specifically formed for the purpose of purchasing such shares, in which event the number of its shareholders, partners or other beneficial owners is counted in determining the number of purchasers. [Corps.C. § 25102(f)(4); Commr. Rule 260.102.12(*l*)]

(b) [5:265] **Excluded purchasers:** Certain investors are deemed to have the ability to fend for themselves, and therefore are *not* counted as part of the 35-purchaser group. Sales may be made to the following investors, therefore, *in addition* to sales made to the 35-purchaser group:

1) [5:266] **Institutional purchasers:** Banks, savings and loan associations, governmental agencies, certain college endowments and certain corporations having a net worth of at least $14,000,000. [See Corps.C. § 25102(f)(4); and Commr. Rule 260.102.10]

This includes:

— *small business investment companies* licensed under § 301(c) or (d) of the Small Business Investment Company Act;

— *business development companies*, as defined in § 2(b)(48) of the Investment Company Act of 1940; and

— *private business development companies*, as defined in § 202(a)(22) of the Investment Advisors Act of 1940. [Commr. Rule 260.102.13(f)]

2) [5:267] **Officers, directors or affiliates** of the issuer (except affiliates formed for the purpose of acquiring the shares in question). [Corps.C. § 25102(f)(4)]

a) [5:268] If the issuer is a partnership, the general partners are excluded; and if the issuer is a trust, the trustees are excluded—provided such partners or trustees exercise *managerial functions*. [Commr. Rule 260.102.13(a)]

b) [5:269] Also excluded is any other person occupying a position with the issuer whose duties and authorities are similar to a corporate executive officer. [Commr. Rule 260.102.13(b)]

c) [5:270] Also excluded is any entity that is *more than 50% owned* by an officer or director of the issuer, or other excluded purchaser, either alone or in combination with a spouse and/or trustee or custodian acting for their minor children. [Commr. Rule 260.102.13(c)(3)]

3) [5:271] **Promoters** of the issuer—i.e., a person who, alone or in conjunction with one or more other persons, takes the initiative in founding and organizing the issuer's business. [See Commr. Rule 260.102.12(f), 260.102.13(d)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

4) [5:272] **$150,000 purchasers:** A purchaser of at least $150,000 of securities is not counted as part of the 35-person limit if (1) the issuer "reasonably believes" the purchaser meets, or (2) the purchaser in fact does meet, either of the following tests:

• The purchaser (or their investment advisor) is able to protect their own interests (*see ¶ 5:279*); or

• The investment does not exceed 10% of the purchaser's net worth (or joint net worth with spouse). [Commr. Rule 260.102.13(e)]
The Commissioner's Rules do not state whether the $150,000 purchaser exclusion applies both to cash and noncash investors.

[5:273] ***Reserved.***

a) [5:274] **Compare—Reg. D:** Federal Reg. D no longer provides a similar "heavy-hitter" exclusion based on the size of the investment.

5) [5:275] **"Accredited" investors:** "Accredited" investors, as defined in SEC Rule 501(a) (¶ 5:174 ff.), are also excluded from the 35-purchaser limit. [Commr. Rule 260.102.13(g)]

6) [5:276] **"Wholly-owned entities"** (comparable to the Reg. D exclusion discussed at ¶ 5:174.6): Corporations, partnerships or other entities wholly owned by any excluded purchaser are also excluded … except if owned by a "$150,000 purchaser" (i.e., such an entity would have to be counted in the 35-member limit). [See Commr. Rule 260.102.13(h)]

7) [5:276.1] **Verifying excluded status:** Issuers often require written questionnaires from proposed investors to establish that they meet the sophistication or financial requirements for "excluded" status (¶ 5:265 ff.).

a) [5:276.2] **Reliance on purchaser representations:** Under SEC Rule 501, and presumably under Commr. Rule 260.102.13(g), the issuer's good faith and reasonable reliance on information furnished by the proposed investor establishes their "accredited" status (*see ¶ 5:175*). Similarly, the issuer should be protected by good faith and reasonable reliance on information provided by $150,000 purchasers … although Rule 260.102.13(e) does not expressly so state.

b) [5:276.2a] **Compare—Rule 506(c) offerings:** Self-certification of the "accredited" status of purchasers under SEC Rule 506(c) offerings is not sufficient; the issuer must satisfy the verification requirements of SEC Rule 506(c)(2)(ii). *See* ¶ 5:181.1 ff.

• ***FORM:*** Offeree Questionnaire, *see Form 5:C*.

(4) Qualifications of counted purchasers

(a) [5:277] **Tests for qualification:** All purchasers counted as part of the 35-purchaser limit must meet *one* of the following tests:

1) [5:278] **"Pre-existing relationship" test:** The purchasers must have a pre-existing *personal or business relationship* with the issuer or any of its officers, directors or controlling persons. This includes any contacts of a nature and duration sufficient to enable a reasonably prudent investor to be *aware* of the character, business acumen, and general business or financial circumstances of the person with whom the relationship exists. [Corps.C. § 25102(f)(2); Commr. Rule 260.102.12(d)(1); see *People v. Simon* (1995) 9 C4th 493, 502, 37 CR2d 278, 283, fn. 8]

a) [5:278.1] **Objective standard utilized:** This "pre-existing relationship" test is applied using an *objective* rather than a subjective standard (i.e., according to what knowledge such a "reasonably prudent investor" would gain from the relationship). [See, e.g., *People v. Simon* (1995) 9 C4th 493, 502, 37 CR2d 278, 283, fn. 8; *People v. Graham* (1985) 163 CA3d 1159, 1172, 210 CR 318, 327-328]

Caution: Being merely an employee or existing security holder does not automatically establish a sufficient relationship. [Commr. Rule 260.102.12(d)(1)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2) [5:279] **“Financial experience” test:** *Or*, the purchasers must have sufficient *business or financial experience* (either alone or through advice of independent professional advisors) so that they could reasonably be assumed to have the capacity to protect their own interests. [Corps.C. § 25102(f)(2)]

a) [5:279.1] **Applied from issuer's point of view:** This test is applied from the *issuer's* (rather than the offeree's) point of view: The purchasers whom the issuer cannot reasonably believe possess the requisite qualifications do not qualify, even if they in fact possess such qualifications. [See, e.g., *People v. Graham* (1985) 163 CA3d 1159, 1172, 210 CR 318, 327-328—experienced undercover agent posing as gullible investor could not qualify as sophisticated investor]

(b) [5:280] ***Each “counted” purchaser must qualify:*** If any *one* of the *counted* purchasers lacks the requisite relationship or financial experience, *the entire exemption fails* (not just the sale to that purchaser).

(c) [5:281] **Excluded purchasers need not qualify:** However, the pre-existing relationship and financial experience qualifications do not apply to accredited investors and other excluded purchasers. Rationale: They would invariably meet these requirements. [Commr. Opns. 83/2C, 83/3C (1983)] (The Commissioner has adopted Rule 260.102.12(d)(2) to make this clear.)

(d) [5:282] **Professional advisor qualifications:** If the exemption is based on the purchaser's having received advice from a third person in connection with the investment, that third person must be:

• A *professional* advisor;

• *Unaffiliated* with the issuer;

• Not compensated, directly or indirectly, by the issuer or any affiliate or selling agent of the issuer for the advice given; and

• Have sufficient business or financial experience to advise the purchaser in connection with the transaction. [Corps.C. § 25102(f)(2); Commr. Rule 260.102.12(g), (h)]

1) [5:283] **Compare—federal rule:** Under Regulation D, it is sufficient if the purchaser receives advice from a “purchaser's representative” … who may or may not be a *professional* financial advisor. (*See* ¶ *5:177*.)

However, the California rule definitely requires a *professional* business or financial advisor; i.e., someone customarily employed for compensation to provide recommendations or decisions. [See Commr. Rule 260.102.12(g)]

2) [5:284] **Need not be registered investment advisor:** On the other hand, the professional advisor need *not* be licensed as an “investment advisor” under federal or state law, nor necessarily possess the qualifications required for such licensing. [See Corps.C. §§ 25009, 25230 et seq.; Commr. Rule 260.102.12(g)(1)]

3) [5:284.1] **Attorneys, accountants and others:** Under the Commissioner's rules, the term “professional advisor” specifically includes attorneys and certified public accountants. [Commr. Rule 260.102.12(g)]

It also includes licensed real estate brokers acting with respect to real estate transactions exempt from broker-dealer registration requirements under Corps.C. § 25206 (i.e., noncorporate transactions involving 100 or fewer persons). [Commr. Rule 260.102.12(g)(1)]

4) [5:285] **Disclosures of adverse interest not sufficient:** To qualify under this exemption, a professional advisor must be independent—i.e., no affiliation with or compensation from the issuer, directly or indirectly. These prohibitions *cannot* be avoided simply by disclosing the facts regarding any such affiliation or compensation to the purchaser. [Commr. Rule 260.102.12(h)]

(5) [5:286] **Purchaser representations:** *All* purchasers—whether or not counted as part of the 35-purchaser limit—must represent to the issuer that they are purchasing for their own account (or a trust account if the purchaser is a trustee), and *not* with the intent to sell same in connection with any “distribution” of the security. [Corps.C. § 25102(f)(3)]

(a) [5:287] **In writing:** The statute does not specifically require that such purchaser representations be made in writing. However, as a practical matter, no issuer could rely on oral representations.

1) [5:287.1] **Investment letter:** The written representations may be obtained by requiring the purchaser to sign an investment letter.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• ***FORM:*** Investment Letter, *see Form 5:A*.

2) [5:287.2] **Subscription agreements:** Subscription agreements (i.e., contracts to purchase corporate stock) may also contain the requisite representations. If such an agreement is used, an investment letter is unnecessary.

• ***FORM:*** Subscription Agreement, *see Form 5:B.*

(b) [5:288] **No specific holding period:** The purchaser's intent *at the time of purchase* is the important thing. The fact that circumstances change, and the purchaser decides to sell the securities earlier than anticipated, does not retroactively destroy the exemption. No specific holding period (as under federal SEC Rules 144, 147 or 147A) is imposed.

(c) [5:289] **Intent not to sell in any "distribution":** The statute requires that the purchaser represent they do *not* intend to sell in connection with any "distribution" of the security (see ¶ 5:242.5).

1) [5:290] **Comment:** The meaning of the term "distribution" is unclear and is not defined in the Commissioner's Rules. However, it undoubtedly includes any *planned resale* (i.e., a purchase with an existing intent to resell) to others who do not possess the requisite qualifications, or who would cause the 35-purchaser limit to be exceeded, if counted as initial purchasers.

2) [5:291] **Where distribution contemplated:** There may be cases where the purchaser is *not* acquiring for its own account, but intends to distribute same: For example, suppose, for tax purposes, a corporation or partnership intends to acquire the securities and immediately liquidate, distributing the securities to its shareholders or partners. In such a case, despite the purchaser's lack of investment intent, a Corps.C. § 25102(f) exemption may still be available. Under the Commissioner's interpretation, the corporation or partnership may be treated as a conduit if the recipient shareholders or partners meet the statutory requirements (see Commr.Opn. 83/1C (1983)). Accordingly, it is the distributees who must meet the "purchaser qualifications" and provide the requisite investment representations (¶ 5:286).

(6) [5:292] **Prohibition on advertising or general solicitation:** Like the Corps.C. § 25102(h) exemption (¶ 5:240) and most offerings under Reg. D (¶ 5:121, 5:173), Corps.C. § 25102(f) contains an express prohibition against public advertisements or general solicitations. [Corps.C. § 25102(f)(4); see Corps.C. § 25002 ("advertisement" defined)]

(a) [5:293] **Limited disseminations permitted:** However, the Financial Protection and Innovation Commissioner's Rules encourage and facilitate the circulation of disclosure materials to offerees and purchasers—so long as they are not disseminated *publicly*. Private placement memoranda and offering circulars may be distributed *provided* the issuer limits their circulation to persons the issuer "*reasonably believes*" to be interested in purchasing the securities or to possess the requisite purchaser qualifications. [Commr. Rule 260.102.12(j)]

1) [5:293.1] **Application:** The Commissioner's Rule permits circulation to persons whom the issuer "reasonably believes to be interested in purchasing the securities," even *before* determining that they possess the requisite purchaser qualifications. [Commr. Rule 260.102.12(j)]

2) [5:293.2] **Caution:** But the tenor of such contacts must not involve *general* solicitation or advertising. For example, the holding of any seminar or meeting whose attendees were invited by any general solicitation or advertising would be prohibited; so would any advertisement, article, notice or other communication in the print or broadcast media. [Commr. Rule 260.102.12(j)(2)(A),(B)]

(7) [5:294] **Notice to Department of Financial Protection and Innovation Commissioner:** An issuer relying on this exemption must file a notice with the Financial Protection and Innovation Commissioner. [Corps.C. § 25102(f)(4); Commr. Rule 260.102.14]

FORM: The Commissioner's form, Notice of Transaction Pursuant to Corporations Code Section 25102(f) (Form DBO-260.102.14(c)), may be filled in and downloaded from the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

(a) [5:294.1] **Online filing required:** Absent hardship (*¶ 5:294.2*), the notice must be filed electronically at the Department's Self Service Portal (*https://docqnet.dfpi.ca.gov*) and the filing fees (*¶ 5:299 ff.*) paid by credit card. [See Commr. Rule 260.102.14(a)(2), (e)]

1) [5:294.2] **Hardship exception:** The issuer may file a Corps.C. § 25102(f) notice in paper form (in person or by mail) where (i) computer equipment (including software) is unavailable to the issuer without unreasonable burden or expense *or* (ii) the issuer cannot obtain and provide the information (including credit card or other identifying

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

information) needed for the electronic filing without unreasonable burden or expense. [Commr. Rule 260.102.14(a)(2), (f)]

[5:294.3 - 5:294.4] ***Reserved.***

(b) [5:294.5] **Filing copy of Form D:** The Commissioner's Rule conforms to Reg. D reporting requirements (*see ¶ 5:136*). Thus, issuers using Reg. D may file with the Department of Financial Protection and Innovation a copy of the version of Form D that was filed with and accepted by the SEC. The Form D is deemed the appropriate notice to be filed under Corps.C. § 25102(f), and the cover letter should indicate the Form D is being filed pursuant to § 25102(f). [Commr. Rule 260.102.14(a)(1); Commr.Rel.No. 120-C (2009)]

(c) [5:295] **Failure to file notice does *not destroy exemption:*** The statute itself provides that failure to file the notice, or to file same within the required time limits (¶ 5:297 ff.), does *not* affect availability of the exemption. Rather, the effect of failure to file the required notice is a *fee penalty* (¶ 5:299.1). [Corps.C. § 25102(f)(4)]

➪ [5:296] ***PRACTICE POINTER:*** Even so, it is sound practice to file the notice. Doing so fulfills the requirements of the exemption and also avoids the possibility of a fee penalty.

(d) Time limits for filing notice

1) [5:297] **Within 15 days after first sale:** Under the Commissioner's Rule, the issuer is required to file the notice *within 15 calendar days* after the first sale of a security in the transaction in California. The “first sale” in California occurs when the issuer has obtained a contractual commitment in this state for the purchase of a security. [Commr. Rule 260.102.14(b)]

2) [5:298] **Otherwise, within 15 days after demand or discovery of failure to file:** If the issuer fails to file the notice as required by the Commissioner's Rule (¶ 5:297), the issuer must file the notice within 15 business days after demand by the Commissioner or discovery of such failure, *whichever occurs first*. The issuer may also be required to pay a higher “penalty” fee (*¶ 5:299.1*). [Corps.C. § 25102(f)(4)]

(e) [5:299] **Fee:** A filing fee is required:

- If the Notice of Transaction Pursuant to Corps.C. § 25102(f) is filed (*¶ 5:294*), the fee is calculated according to the size of the issuance in the same manner as under Corps.C. § 25102(h) (*see ¶ 5:251*). [Corps.C. §§ 25102(f)(4), 25608(c); Commr.Rel.No. 115-C (revised 2004)]

- If a copy of the issuer's Form D is filed (*¶ 5:294.5*), the filing fee is $300 regardless of the size of the offering. [Corps.C. § 25608.1(c); Commr.Rel.No. 120-C (2009)]

1) [5:299.1] **Late filing penalty:** However, if the notice is filed following demand by the Commissioner, or if the notice is otherwise filed late because the obligation to file within 15 days after the first sale was *intentionally disregarded* (¶ 5:297 ff.), the issuer must pay a higher fee—as if applying for qualification of the shares (based on the value of the securities, ranging from $200 to $2,500). [Corps.C. §§ 25102(f)(4), 25608(e)]

[5:299.2 - 5:299.4] ***Reserved.***

(f) [5:299.5] **Commissioner's authority unaffected by filing of notice:** Neither the filing of the notice, nor the Commissioner's failure to comment on the notice, precludes the Commissioner from taking any action that they deem necessary or appropriate under the Corporate Securities Law with respect to the offering. [Corps.C. § 25102(f)(4)]

(g) [5:300] **Consent to service of process:** Issuers *other than California corporations* must file a Consent to Service of Process, unless they have previously done so or have filed a copy of their Form D filing (*¶ 5:294.5*), appointing the Financial Protection and Innovation Commissioner as agent for service of process in any action arising under the Corporate Securities Law as the result of share issuance. [Corps.C. § 25165; see Commr. Rule 260.165; Commr.Rel.No. 120-C (2009)]

- ***FORM:*** The Commissioner's standard form Consent to Service of Process (Form DBO-260.165) may be filled in and downloaded from the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

(h) [5:300.1] **Additional notice required for realty-related issuers:** An issuer engaged in the business of *purchasing, selling, financing or brokering real estate* that offers or sells any security in reliance on the Corps.C. § 25102(f) exemption must file a notice with the Financial Protection and Innovation Commissioner if an offer or sale is made to any person who is not an "accredited" investor (as defined in Reg. D, ¶ 5:174 ff.). The notice must be filed within the time specified for filing the § 25102(f) notice (¶ 5:297 ff.). The notice may be filed online at the Department's Self Service Portal (*https://docqnet.dfpi.ca.gov*) or, alternatively, in person or by mail at any office of the Department of Financial Protection and Innovation's Division of Corporations. [Corps.C. § 25102.2; Commr.Rel.No. 121-C (2012); *see further discussion at* ¶ 5:223.5 ff.]

(8) [5:301] **Comment—usefulness of § 25102(f) exemption:** This exemption provides much more flexibility for corporate share issuances than is available under Corps.C. § 25102(h). The following are its principal advantages:

- There is no limit on the *amount* of shares that can be sold, or the *type* of consideration which can be paid therefor (beyond that set forth elsewhere in the Corporations Code).

- There is no prohibition on sales commissions in connection with the sale.

- The exemption is available not only as to shares, but also as to any other type of security.

(a) [5:301.1] **Entity conversions:** Also, satisfying the Corps.C. § 25102(f) conditions is one of the prerequisites for obtaining an exemption under Corps.C. § 25103(h)(1) for an entity conversion transaction; *see ¶ 8:451 ff.*

(b) [5:302] **Compare:** There may be situations, of course, where the Corps.C. § 25102(f) exemption will not work:

1) [5:303] **Issuances to "strangers":** For example, one or more of the investors is a "stranger" (no pre-existing business or social relationship) and lacks sufficient business and financial experience to qualify as a Corps.C. § 25102(f) purchaser.

In such cases, if the requirements of Corps.C. § 25102(h) can be met, it may be preferable to file a notice of issuance under that exemption, rather than risk the consequences of a later determination that the issue was nonexempt under § 25102(f).

2) [5:304] **Certain reorganizations:** Also, it is important to note that Corps.C. § 25102(f) does not apply to *mergers* and certain reorganization or exchange transactions that are required to be qualified by permit under Corps.C. § 25120 (*see ¶ 8:230*).

However, it *does* extend to recapitalizations that involve only changes in rights, preferences, privileges and restrictions. [Commr. Rule 260.103; *see ¶ 8:86*]

It could also extend to exchanges exclusively with existing security holders. Thus, § 25102(f) could be used, for example, to exempt the issuance of new common shares "in exchange" for outstanding shares previously issued under the Corps.C. § 25102(h) exemption. (This was not possible when § 25102(h) shares were subject to transfer and legend restrictions (*¶ 5:242.6*; see Commr.Opn. 85/1C (1985)).) [Commr. Rule 260.103] But the issue is moot to the extent exchanges exclusively with existing shareholders are exempt from qualification *where no commission is paid* (*see ¶ 8:153*).

[5:304.1 - 5:304.5] ***Reserved.***

g. [5:304.6] **"Qualified purchaser" limited public offering exemption (§ 25102(n)):** This is the broadest exemption under the California Corporate Securities Law. It exempts potentially unlimited offers and sales of securities by specified California issuers to "qualified purchasers," who may be solicited by way of a written *public announcement* (*¶ 5:304.19 ff.*). [Corps.C. § 25102(n)]

- [5:304.6a] **Corresponding federal exemption:** Offerings that are exempt under § 25102(n) *and that do not exceed $5 million* are also exempt from federal registration requirements. However, purchasers receive "restricted securities," and must either register subsequent resales or establish an exemption for the resales. [SEC Reg. CE, Rule 1001 (17 CFR § 230.1001)]

(*Note:* Corps.C. § 25102(n) has not been amended to reflect the adoption of SEC Rule 1001. Where the offering does not exceed $5 million, references in § 25102(n) to Reg. D should be interpreted to require compliance with all provisions of Reg. D other than provisions relating to filings with the SEC. Where the offering exceeds $5 million, the issuer may

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

proceed under SEC Rule 504 (for offerings up to $10 million; ¶ 5:107 ff.) or SEC Rule 506 (¶ *5:171 ff.*), unless some other exemption from federal registration, such as the intrastate offering exemption (¶ *5:81 ff.*), is available.)

(1) [5:304.7] **Purpose:** The principal purpose of the Corps.C. § 25102(n) exemption is to allow businesses to identify and publicly solicit investment from two broad categories of investors: the kind of sophisticated and/or affluent investors who are considered "accredited" under Reg. D and "excluded" or "qualified" under Corps.C. § 25102(f); and, under specified conditions, other investors with lesser qualifications, but who are also considered capable of protecting their own interests in connection with the proposed investment (*see* ¶ *5:304.10*).

(2) [5:304.8] **No limit on amount of offering or number of offerees or purchasers:** There is no limit on the dollar amount of securities or on the number of persons to whom offers or sales of securities may be made in reliance on the Corps.C. § 25102(n) exemption.

(a) [5:304.9] ***Caution—offerings exceeding $5 million:*** The federal exemption under SEC Rule 1001 (¶ *5:304.6a*) does not apply where the offering exceeds $5 million. In such event, the offering must comply with SEC Rule 504 (if the offering is below $10 million; ¶ 5:107 ff.), SEC Rule 506 (¶ *5:172 ff.*), or qualify for some other exemption from federal registration (such as the federal intrastate exemption, ¶ *5:81 ff.*).

(3) [5:304.10] **"Qualified purchasers":** Sales may be made only to "qualified purchasers" (or to persons the issuer reasonably believes, after reasonable inquiry, to be "qualified" purchasers). [Corps.C. § 25102(n)(2)]

"Qualified purchasers" include:

• Persons excluded from the count of purchasers ("excluded" purchasers) in the limited offering exemption under Corps.C. § 25102(f) and under Rule 260.102.13 (i.e., officers, directors, promoters, certain wealthy investors, etc.; *see* ¶ *5:267 ff.*). [Corps.C. § 25102(n)(2)(A)]

• Certain institutional investors set forth in Corps.C. § 25102(i) (i.e., banks, insurance companies, investment companies, etc.). [Corps.C. § 25102(n)(2)(B)]

• A pension or profit-sharing trust of the issuer, self-employed retirement plan or individual retirement account, if all investment decisions are made by otherwise qualified purchasers. [Corps.C. § 25102(n)(2)(C)]

• A nonprofit organization having more than $5 million in assets. [Corps.C. § 25102(n)(2)(D)]

• A corporation, partnership or other organization formed to invest in the offering, if all its equity owners are themselves qualified purchasers. [Corps.C. § 25102(n)(2)]

• Natural persons meeting designated suitability standards (¶ 5:304.11 ff.). [Corps.C. § 25102(n)(2)(E)]

(a) [5:304.11] **Natural persons meeting high suitability standards as "qualified purchasers":** Natural persons (i.e., an individual or married couple) are also "qualified persons" so long as (i) the offered securities consist solely of either one-class voting common stock or preferred stock having at least the same voting rights as the issuer's one-class voting common stock, and (ii) *all* of the following conditions are satisfied:

1) [5:304.12] **Sophistication:** Each such person, by reason of their business or financial experience (or relying on the business or financial experience of a professional advisor who is neither affiliated with nor compensated by the issuer), can be reasonably assumed to have the capacity to protect their own interests in the transaction. [Corps.C. § 25102(n)(2)(E)]

2) [5:304.13] **Financial ability:** The amount of the investment does not exceed 10% of the individual's (or couple's) net worth; and the individual or couple have *either* (i) net worth of at least $500,000 *or* (ii) net worth of at least $250,000 *and* annual income in the preceding tax year of at least $100,000 (and reasonably anticipated similar income in the present year). Net worth is determined exclusive of home, home furnishings and automobiles. [Corps.C. § 25102(n)(2)(E)]

3) [5:304.14] **Disclosure statement:** At least five days before any sale or acceptance of a commitment to purchase securities, the issuer provides the individual or couple with a disclosure statement meeting the disclosure requirements of Reg. D (*see* ¶ 5:182 ff.) and any other rule of the Commissioner. [Corps.C. § 25102(n)(4)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [5:304.15] **Disclosure requirement not applicable to § 25102(f) "excluded" purchasers:** This disclosure requirement applies only to *natural persons* (including any entity specifically formed by natural persons for the purpose of acquiring the securities) who are *not* "excluded" purchasers under Corps.C. § 25102(f) and Rule 260.102.13 (¶ *5:267 ff.*). Accordingly, disclosure statements need not be delivered where the offering is structured to include only Rule 250.102.13 offerees and other qualified purchaser entities (¶ *5:304.10*). [Corps.C. § 25102(n)(4)]

1/ [5:304.16] **Caveat—Rule 506 offerings over $5 million:** Where the offering exceeds $5 million and the federal exemption being relied upon is SEC Rule 506, the Reg. D disclosure requirements must be met if there are any "nonaccredited" purchasers (*see* ¶ *5:182 ff.*). (If the offering is less than $10 million, the issuer may instead rely on the SEC Rule 504 exemption, which only requires that investors receive information about resale restrictions; ¶ 5:119.)

b) [5:304.17] **Exemption not lost by disclosure defects:** Offers or sales pursuant to a disclosure statement that fails to meet the Reg. D requirements, or that violates the Corps.C. § 25401 antifraud provisions (¶ *5:390 ff.*), will *not* result in loss of the exemption. [Corps.C. § 25102(n)(4)]

[5:304.18] *Reserved.*

(4) [5:304.19] **Public solicitation:** An issuer may publicize its offering by way of a limited written general announcement, provided the announcement is restricted to specified facts about the offering. *No telephone solicitation* of an investor is permitted without first determining that the prospective investor is a "qualified purchaser" (but a prospective investor may contact the issuer by mail or telephone in response to the announcement; see ¶ 5:304.20). [Corps.C. § 25102(n)(5), (6)]

Dissemination of the announcement to persons who are not qualified purchasers, without more, will *not* disqualify the issuer from claiming the exemption. [Corps.C. § 25102(n)(5)(D)]

(a) [5:304.20] **Mandatory contents of announcement:** The announcement *must* state:

• The issuer's name;

• The full title of the security;

• The anticipated suitability standards for investors;

• That no money or other consideration is being solicited or will be accepted, and a prospective purchaser's indication of interest involves no obligation or commitment of any kind;

• Any other information required by rule of the Commissioner;

• The following legend: "For more complete information about (Name of Issuer) and (Full Title of Security), send for additional information from (Name and Address) by sending this coupon or calling (Telephone Number)";

• In addition, if the offering requires delivery of a written disclosure statement (¶ 5:304.14), the announcement must state that the issuer will not make any sales or accept any commitments to purchase for five business days after delivery of the disclosure statement (and any subscription agreement) to the prospective purchaser. [Corps.C. § 25102(n)(5)(A)]

(b) [5:304.21] **Optional contents:** The announcement *may* (optionally) also state the following, but *no more:*

• A brief description of the issuer's business;

• The location of the issuer and its business;

• The price of the security, or if not yet determined, the probable price range or method that will be used to compute the price; and the aggregate offering price. [Corps.C. § 25102(n)(5)(B), (C)]

(5) [5:304.22] **Purchaser's representations:** Each purchaser must represent that they are purchasing for their own account and not with a view to or for sale in connection with a distribution of the security. [Corps.C. § 25102(n)(3)]

(6) [5:304.23] **Limitations on issuers and transactions:** The Corps.C. § 25102(n) exemption is available only to corporations or other forms of business entity organized in California, and to "pseudo-foreign" corporations (i.e., foreign corporations subject to Corps.C. § 2115; *see* ¶ *3:5 ff.*). [Corps.C. § 25102(n)(1)(A), (B)]

The exemption is *not* available for offers or sales of securities in a "rollup" transaction, by a "blind pool" issuer (¶ *5:110*) or by an investment company subject to the Investment Company Act of 1940. [Corps.C. § 25102(n)(1)]

(7) [5:304.24] **Notices to Commissioner:** The issuer must file two notices of transaction with the Commissioner. [Corps.C. § 25102(n)(7); Commr. Rule 260.102.16]

(a) [5:304.25] **Time of filing:** The *first* notice must be filed at the *earlier* of (i) the publication of the general announcement of the proposed offering (¶ *5:304.19*) or (ii) the initial offer of the securities. [Corps.C. § 25102(n)(7)]

- ***FORM:*** The Commissioner's form, First Notice of Transaction Pursuant to Corporations Code Section 25102(n) (Form DBO-25102(n) First Notice), may be filled in and downloaded from the Department of Financial Protection and Innovation's website (*www.dfpi.ca.gov*).

  The *second* notice must be filed within *10 business days* after the close of the offering, but in no event later than *210 days* after filing the first notice. [Corps.C. § 25102(n)(7)]

- ***FORM:*** The Commissioner's form, Second Notice of Transaction Pursuant to Corporations Code Section 25102(n) (Form DBO-25102(n) Second Notice), may be filled in and downloaded from the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

(b) [5:304.26] **Undertaking to file disclosure statement:** The first notice (¶ 5:304.25) contains an undertaking to file with the Commissioner, within 10 days after request, any disclosure statement to be delivered to prospective purchasers in connection with the offering. The Commissioner may assess a penalty of up to $1,000 for failure to comply. [Corps.C. § 25102(n)(7)]

(c) [5:304.27] **Filing fee:** The fee for filing the *first* notice (¶ *5:304.25*) is $600. (There is no fee for filing the second notice.) [Corps.C. § 25608(x)]

(d) [5:304.28] **Online filing:** Both notices may be filed online, and any filing fee paid by credit card, at the Department's Self Service Portal (*https://docqnet.dfpi.ca.gov*).

(e) [5:304.29] **Exemption lost for failure to file first notice/fee:** The exemption is unavailable if an issuer fails to file the first notice (¶ *5:304.25*) or to pay the filing fee (¶ *5:304.27*). [Corps.C. § 25102(n)(7)]

(f) [5:304.30] **Additional notice required for realty-related issuers:** An issuer engaged in the business of purchasing, selling, financing or brokering real estate that offers or sells any security in reliance on the Corps.C. § 25102(n) exemption must file a notice with the Financial Protection and Innovation Commissioner if an offer or sale is made to any person who is not an "accredited" investor (as defined in Reg. D, ¶ 5:174 ff.). The notice must be filed together with, and within the time specified for, the § 25102(n) notices (¶ 5:304.25 ff.). [Corps.C. § 25102.2; Commr.Rel.No. 121-C (2012); *see further discussion at* ¶ *5:223.5 ff.*]

h. [5:305] **Exemption for stock option/purchase plans:** Also exempt from the California qualification requirements is the offer or sale of a security issued by a corporation or LLC pursuant to a stock option or stock purchase plan or agreement where the security is exempt from federal registration under SEC Rule 701. [Corps.C. § 25102(o)]

(Rule 701 provides a federal exemption for offers and sales pursuant to employee benefit and compensation plans by issuers that are not 1934 Act reporting companies; *see* ¶ *5:189.1 ff.*)

(1) [5:305.1] **Exemption conditions:** In addition to the requirements of Rule 701, the plan must satisfy several other conditions, including:

- The total number of shares exercisable under *all* equity incentive plans may not exceed 30% of the company's then-outstanding shares unless a higher percentage is approved by at least two-thirds of the outstanding shares entitled to vote (but this 30% limitation does not apply to a plan that complies with SEC Rule 701, ¶ *5:189.1 ff.*);

- The company's financial statements must be provided to all plan participants annually unless the plan is limited to key employees who have access to equivalent information (but annual financial statements are not required for plans complying with Rule 701, ¶ *5:189.1 ff.*);

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- The exercise period must be no more than 10 years from the grant date;
- The options must be nontransferable (other than by death or as permitted by Rule 701);
- The optionees must be given antidilution rights;
- Unless terminated for cause (as defined by the applicable law, employment contract, or plan or option grant), a terminated employee must be permitted to exercise the option for at least *30 days* from the date of termination (*six months* if termination was caused by death or disability); *and*
- The option plan must be approved by the shareholders within 12 months before or after the *later* of (i) its adoption or (ii) the granting of any option or issuance of any security under the plan in California. [Commr. Rule 260.140.41, 260.140.42, 260.140.45, 260.140.46]

(2) [5:305.2] **Notice to Commissioner:** The issuer must file a notice of transaction within 30 days after the grant (in the case of stock options) or purchase (in the case of stock purchase plans). The notice must be accompanied by a filing fee equal to $200 plus 0.2% of the value of the securities, with a maximum fee of $2,500. [Corps.C. §§ 25102(o), 25608(y)]

FORM: The Commissioner's form, Notice of Issuance of Securities Pursuant to Subdivision (o) of Corporations Code Section 25102(o) (Form DBO-260.102.19), may be filled in and downloaded from the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

(a) [5:305.2a] **Online filing:** The notice may be filed online, and the filing fee paid by credit card, at the Department's Self Service Portal (*https://docqnet.dfpi.ca.gov*).

(b) [5:305.3] **Exemption not defeated by failure to file notice:** As in the case of Corps.C. § 25102(f) and Corps.C. § 25102(h), the exemption is available even if the notice is not filed. However, an issuer that fails to file the notice must, within 15 business days after demand by the Commissioner or discovery of such failure, *whichever occurs first*, file the notice and pay a fee equal to the maximum aggregate fee payable had the transaction been qualified—i.e., $2,500. [Corps.C. § 25102(o)]

➪ [5:305.3a] ***PRACTICE POINTER:*** It is sound practice to file the notice. Doing so fulfills the requirements of the exemption and also avoids the possibility of having to pay a higher fee as a "penalty" (¶ 5:305.3).

(3) [5:305.4] **Previously qualified issuance—exemption available for plan amendments:** An issuer that has qualified the issuance of securities under its plan may use the exemption for a prospective plan amendment. Of course, all the conditions of the exemption must be met, including the notice filing and fee requirements (*¶ 5:305.1 ff.*). [Commr.Rel.No. 99-C (1996)]

(a) [5:305.5] **Amendment requiring qualification—new notice and fee required:** An amendment that requires qualification, including an amendment to increase the number of options or shares that may be issued under the plan, requires the filing of a new notice and payment of an additional fee based on the value of the underlying securities that are being issued under the exemption. [Commr.Rel.No. 99-C (1996)]

(4) [5:305.6] **No integration with other offers/sales:** Offers and sales of securities exempt under § 25102(o) are deemed part of a single, discrete offering and hence are *not* subject to integration (*¶ 5:311 ff.*) with *any other offering or sale*. [Corps.C. § 25102(o)]

[5:305.7 - 5:305.9] ***Reserved.***

i. [5:305.10] **Exemption for securities exchanged in merger or asset sale:** Another important exemption covers certain securities issued pursuant to a merger, consolidation or sale of assets; *see discussion at ¶ 8:232.1 ff.*

[5:305.11 - 5:305.14] ***Reserved.***

j. [5:305.15] **Exemption for licensed "capital access company" securities:** A private offer or sale of *nonredeemable* securities to certain *accredited investors* by a licensed "capital access company" is exempt from qualification. [Corps.C. § 25102(p)]

(1) [5:305.16] **“Capital access company” defined:** A “capital access company” is an investment company licensed under the California Capital Access Company Law (Corps.C. § 28000 et seq.) to provide risk capital and management assistance primarily to small business firms (those with fewer than 500 employees) in California. A “capital access company” is exempt from the federal Investment Company Act of 1940. [Corps.C. §§ 28003, 28004(a), 28047, 28400; 15 USC § 80a-6(a)(5)]

(2) [5:305.17] **“Accredited investors”:** For purposes of this exemption, “accredited investor” means a person defined in SA § 2(a)(15) or otherwise designated as an “accredited investor” by SEC rule, regulation or order (*see* *¶ 5:174 ff.*). (It is the accredited investors who, by purchasing the capital access company's securities, provide the investment funds with which the company provides financial assistance to small business firms.) [Corps.C. § 28031]

(a) [5:305.18] **Pre-existing relationship or investment experience also required:** In addition to being accredited investors, all purchasers must either:

- Have a pre-existing personal or business relationship with the offeror or any of its officers, directors or controlling persons; or

- By reason of their business or financial experience or the business or financial experience of their professional advisers (who are unaffiliated with and not compensated, either directly or indirectly, by the issuer or any affiliate or selling agent of the issuer), could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction. [Corps.C. § 25102(p)]

(b) [5:305.19] **California residency restriction:** The capital access company's organizational documents must provide that not less than 80% of each class of the company's securities be held by persons who either reside or have a “substantial business presence” in California. [Corps.C. § 28200(c)]

(c) [5:305.20] **Legend restricting transfer:** All securities sold under § 25102(p) must be evidenced by certificates bearing the following legend, prominently stamped or printed on the certificate's face in capital letters of not less than 10-point size (Corps.C. § 25102(p); Commr. Rule 280.500):

> “THE SECURITIES REPRESENTED BY THIS CERTIFICATE ARE NOT REDEEMABLE AND MAY BE TRANSFERABLE ONLY TO ACCREDITED INVESTORS AS DEFINED IN SECTION 28031 OF THE CORPORATIONS CODE.”

(3) [5:305.21] **Intrastate offerings—no general solicitation or advertising:** The “licensed capital access company” exemption is *not* available for any offering that is exempt or asserted to be exempt pursuant to the intrastate offering exemption (SA § 3(a)(11) or SEC Rule 147, *¶ 5:81 ff.*) or that is otherwise conducted by any form of general solicitation or general advertising. [Corps.C. § 25102(p)]

(*Caution:* Corps.C. § 25102(p) refers specifically to SEC Rule 147 but not to SEC Rule 147A because it predates Rule 147A. Cautious counsel should treat the “licensed capital access company” exemption as unavailable for a Rule 147A offering until given guidance from the Commissioner.)

(4) [5:305.22] **Licensing requirements:** The Commissioner is charged with administering and enforcing the Capital Access Company Law, including approving applications for license. Licensing requirements include:

- At least $5 million in funds available for investment and a tangible net worth of at least $250,000;

- Additional financial resources adequate to pay projected operating expenses for at least three years after licensure; and

- Evidence that the officers, directors and controlling shareholders possess good character, are of sound financial standing, and are each competent and collectively adequate to manage the company's business. [Corps.C. § 28152(a)-(d); see Commr. Rule 280.151-280.154]

(5) [5:305.23] **Continuous regulation:** A capital access company is subject to extensive statutory regulation as to its organization, operations and recordkeeping, and must file periodic reports with the Commissioner. [Corps.C. § 28200 et seq.; Commr. Rule 280.100-280.700]

k. [5:305.24] **Exemption for small offerings:** As long as other federal and state requirements are satisfied (*see* ¶ 5:305.27 ff.), intrastate offerings (¶ 5:81 ff.) by qualifying corporations (¶ 5:305.26) that do not exceed $300,000 are exempt from the federal "crowdfunding" regulation requiring financial statements be reviewed by an independent certified public accountant (¶ 5:106.13 ff.). Instead, the issuer must submit financial information certified by its principal executive officer to the Department of Financial Protection and Innovation and "prominently provide" a statement that it has done so. [Corps.C. § 25102(r)(2), (3), (11)]

The other federal Regulation Crowdfunding requirements (¶ 5:106 ff.) apply. [Corps.C. § 25102(r)(3)]

(1) [5:305.25] **Comment:** Corporations that qualify (¶ 5:305.26) for the state exemption for small offerings (¶ 5:305.24) can preserve the one-time exemption from the Regulation Crowdfunding's auditing requirements for offerings of up to $1,070,000 and use it for a subsequent offering. [See 17 CFR § 227.201(t)(3); *and* ¶ 5:106.13]

(2) [5:305.26] **Qualifying corporations:** The exemption for small offerings (¶ 5:305.24) is available to California corporations and foreign corporations subject to California law under Corps.C. § 2115 (¶ 3:5 ff.) that are *not*: (a) "blind pool" companies (¶ 5:110); (b) issuing fractional undivided interests in oil or gas rights, or similar interests in other mineral rights; (c) investment companies subject to the Investment Company Act of 1940; or (d) subject to the reporting requirements under SEA § 13 or § 15(d) (¶ 5:56.6). [Corps.C. § 25102(r)(1)]

(3) [5:305.27] **Issuers must ensure non-accredited investors' knowledge and experience:** Purchasers do not need to be "accredited investors" (¶ 5:174 ff.). However, issuers utilizing the exemption for small offerings must take "reasonable steps" to ensure that each purchaser who is a natural person and not an accredited investor "has knowledge and experience in financial and business matters" and is "capable of evaluating the merits and risks of the prospective investment." [Corps.C. § 25102(r)(5)]

(4) [5:305.28] **Purchaser's right to rescind:** Purchasers have a right to rescind any investment made in any security that is offered under Corps.C. § 25102(r) within three days. The three-day period ends at 11:59 p.m. PST on the third business day after the date on which the purchaser receives the issuer's written confirmation of its acceptance of the purchaser's investment. [Corps.C. § 25102(r)(6)]

(5) [5:305.29] **Funds raised must be placed in escrow account:** The issuer must set aside all funds raised as part of an offering that is exempt under Corps.C. § 25102(r) in a separate third-party escrow account until the minimum offering amount (if any) is reached. If the minimum amount is not reached within one year of the offering's effective date, the issuer must return all funds to the purchasers. [Corps.C. § 25102(r)(7)]

(6) [5:305.30] **Direct solicitation by issuers prohibited:** Issuers—on their own or through a third party that is not licensed as a broker-dealer—cannot conduct any direct solicitation of securities offered under Corps.C. § 25102(r). [Corps.C. § 25102(r)(8)]

(7) [5:305.31] **Waiver of purchasers' rights prohibited:** Issuers are prohibited from requiring any purchaser or potential purchaser to enter into an agreement that includes (a) an arbitration clause, (b) a foreign choice-of-law clause, or (c) a foreign forum-selection clause. Purchasers are entitled to (a) a jury trial in a court action, (b) be exclusively bound by and subject to California law, and (c) file and resolve any claim or dispute in a California forum. [Corps.C. § 25102(r)(9)]

(8) [5:305.32] **Notice of transactions and payment of fee required:** At least 15 days prior to publishing an initial offer of securities exempt under Corps.C. § 25102(r), an issuer must file a notice of transactions with the Department of Financial Protection and Innovation and pay a filing fee (*see* ¶ 5:251). The failure to do so does not affect the availability of the exemption as long as the issuer files the notice and pays the requisite fee within 15 business days after discovering the failure to file the notice or after demand by the Commissioner, whichever occurs first. [Corps.C. § 25102(r)(10), (12); see Corps.C. § 25608(c) (fee schedule for notice of transactions under Corps.C. § 25102(r)(10))]

l. [5:306] **Other exempted/"preempted" transactions:** The Corporate Securities Law also exempts certain other transactions, and authorizes the Financial Protection and Innovation Commissioner to exempt, by rule, additional transactions where qualification is not necessary in the public interest or for the protection of investors. Moreover, the 1933 Act preempts state regulation of some of the exempted transactions (*see ¶ 5:18.5 ff.*). [Corps.C. § 25105; *see ¶ 5:195.5a ff.* for exempted *securities*]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Such other exempted or "preempted" transactions include:

(1) [5:306.1] Certain *out-of-state* offers or sales made by or through licensed broker-dealers. [See Commr. Rule 260.105.2]

(2) [5:307] Offers or sales of a security made *to* a licensed broker-dealer for their own account, or for resale pursuant to an exemption, or as an underwriter or member of a selling group. [See Commr. Rule 260.105.2]

(3) [5:307.1] Any bona fide secured transaction in or loan of outstanding securities. [Corps.C. § 25017(f)(1)]

(4) [5:308] Offers or sales of ownership interests in *professional corporations*. [See Commr. Rule 260.105.6; *and ¶ 2:302*]

(5) [5:309] *Incentive stock options* issued by 1934 Act reporting corporations (provided specified conditions are met). [See Commr. Rule 260.105.8]

(6) [5:309.1] Certain recapitalization and exchange transactions. [See Commr. Rule 260.103; *and* ¶ *8:88, 8:153 ff.*]

[5:309.2] ***Reserved.***

(7) [5:309.3] Offers and sales of *debt* instruments rated "investment grade securities" by Standard & Poor's Rating Services, Fitch, Inc. or Moody's Investors Service, Inc. [Commr. Rule 260.105.34]

(8) [5:309.4] Exchange-traded *options* on stock indices or foreign currencies. [See Commr. Rule 260.105.35, 260.105.36]

(9) [5:309.5] Offers or sales of *guarantees*, letters of credit, standby purchase commitments or similar securities obligating the issuer to pay the principal and/or interest on any investment grade *securities of public entities* … *provided* such issuer is a 1934 Act reporting company and meets specified credit, net worth and income requirements. [See Commr. Rule 260.105.38]

(10) [5:309.6] Nonpublic offerings of equipment trust investments. [Corps.C. § 25102(g)]

(*But note:* All offerings of interests in a *railroad* equipment trust are exempt from both federal and state securities law. See SA §§ 3(a)(6), 18(b)(4)(E) (15 USC §§ 77c(a)(6), 77r(b)(4)(E)); Corps.C. § 25102.1(c).)

(11) [5:309.7] Issuances to specified financial and other type institutional investors, or to any 1934 Act reporting corporation (and any wholly owned subsidiary thereof). [Corps.C. § 25102(i)]

(12) [5:309.7a] Offers or sales incident to a transaction or reorganization approved by a state or federal court in which securities are issued and exchanged for outstanding securities, claims or property interests. [Corps.C. § 25017(f)(3)]

(13) [5:309.8] Offerings pursuant to a plan of reorganization under Chapter 11 of the federal bankruptcy law. [Corps.C. § 25102(k)]

(*But note:* Most securities issued in connection with bankruptcy proceedings are *not* subject to federal registration or state qualification requirements; *see ¶ 5:194.11*.)

(14) [5:309.9] Offerings of interests in oil and gas titles or leases to qualified investors. [Corps.C. § 25102(j)]

(15) [5:309.10] Offers and sales to "qualified purchasers" of viatical settlement contracts (or fractionalized or pooled interests therein) meeting specified criteria. [Corps.C. § 25102(q)]

m. [5:310] **Caution—antifraud rules still applicable:** Even if the issuance is exempt, it is still subject to applicable federal and state antifraud rules (SEC Rule 10b-5, *¶ 6:360 ff.*; and Corps.C. § 25401, *¶ 5:390*).

n. [5:311] **Caution—exemptions jeopardized by "integrated offerings":** As stated earlier, to be exempt the share issuance must fit entirely within one or more exemptions. Two or more exemptions cannot be combined to exempt a *single* transaction.

This raises the problem of what is a single transaction. Just as under federal law, several separate share issuances may be treated as a single "integrated" offering … in which case the *entire* offering has to fit within one or more of the above exemptions (¶ 5:306 ff.). In such a case, the fact that each part of the offering could have been exempt under a separate exemption is *not* enough.

(1) [5:312] **Factors affecting whether several offerings deemed "integrated":** The following factors are utilized in determining whether separate share offerings are really part of an "integrated" offering, with the first two factors below generally considered most important (see Commr.Rel.No. 67-C (1981)):

• Whether part of a "single plan of financing."

• Whether the proceeds are used for the same general purpose.

• Whether they involve issuance of the same class of shares.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Whether made at or about the same time.

• Whether same type of consideration is received.

(2) [5:313] **Example:** Suppose a corporation sells common shares to 10 persons in purported reliance on the Corps.C. § 25102(h) exemption. Then, a month later, it sells additional common shares for cash to 35 persons in purported reliance on the Corps.C. § 25102(f) exemption.

If the sales to all 45 purchasers constitute a "single plan of financing" and otherwise warrant the conclusion that they constitute an integrated offering, the transaction would probably be unlawful. The § 25102(h) exemption clearly would not apply because it is limited to 35 beneficial holders. And, the § 25102(f) exemption will likewise be unavailable unless at least 10 purchasers can be excluded from the count; and even then, the counted 35 would have to possess the requisite relationship with the issuer or have financial experience.

[5:313.1 - 5:313.4] ***Reserved.***

(3) [5:313.5] **No integration of securities issued pursuant to option plans/agreements:** Offers and sales of securities issued pursuant to a stock option plan or stock purchase plan or agreement, and exempted from qualification under § 25102(o) (¶ *5:305 ff.*), are deemed part of a single, discrete offering and are *not* subject to integration with *any other offering or sale*. [Corps.C. § 25102(o)]

(4) [5:314] **Safe harbors:** The Financial Protection and Innovation Commissioner has established three "safe harbors" from integration. The principal safe harbor is similar to that provided under Reg. D (*see* ¶ *5:116*): Offers or sales made *more than six months* before the "start of an offering," or after "completion of an offering," are generally *not* considered part of the same offering. [Commr. Rule 260.102.12(b)(1)]

• [5:314.1] **Caution:** This safe harbor is *not* available if there are any offers or sales of similar securities (except under certain employee benefit plans) *within six months* of the start or completion of the offering. [Commr. Rule 260.102.12(b)(1)]

(a) [5:314.2] **Qualified offers or sales:** Additional safe harbors are provided for offers or sales for which qualification is obtained, so long as *either:*

1) The application disclosed the claimed-exempt transaction; or

2) The qualification became effective *after* the issuer filed the requisite exemption notice for the transaction. [Commr. Rule 260.102.12(b)(2)]

(5) [5:314.3] **Avoiding integration outside safe harbors:** The "safe harbors" provided in the regulations are not intended to be the only methods by which integration of offerings can be avoided. [Commr. Rule 260.102.12(b)(2)] But avoiding integration of two or more successive offerings which do not come within the safe harbors will probably require establishing that the offerings *were made for essentially different purposes and do not constitute a single plan of financing*—even if they involve different securities and consideration and are separate in time (*see* ¶ *5:312*). [See *Sherman v. Lloyd* (1986) 181 CA3d 693, 701-702, 226 CR 495, 500-501]

3. [5:315] **Nonexempt Issues; Procedure for Obtaining Permit:** If no exemption is available, the offering and sale will have to be qualified with the Financial Protection and Innovation Commissioner. As already mentioned, larger companies may be able to qualify their issues by "coordination" or "notification" (¶ *5:198 ff.*). However, most smaller companies must qualify by obtaining a permit from the Commissioner. [Corps.C. § 25113]

a. [5:316] **Application for permit:** To obtain a permit from the Financial Protection and Innovation Commissioner, the prospective issuer must prepare and file an application on a prescribed form. [Corps.C. § 25113(b)]

FORM: The Commissioner's form, Application for Qualification of the Offer and Sale of Securities Under the Corporate Securities Law of 1968 (Forms DBO-260.110 and DBO-260.113), may be filled in and downloaded from the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [5:316a] **Standard application:** This form requires, among other things, detailed information concerning the issuer's business, the nature and purpose of the offering, the type of consideration to be received, the intended application of the proceeds, compensation paid to management, and financial statements or a budget. [Commr. Rule 260.113]

Required exhibits to the application include a copy of the issuer's articles of incorporation, bylaws, and any agreements affecting the rights or transferability of its shares.

(a) [5:316.1] **Filing fee:** The fee for filing an application for qualification of the sale of securities by permit is $200 plus 1/5th of 1% of the aggregate value of the securities being sold, up to a maximum fee of $2,500. [Corps.C. § 25608(e)]

(b) [5:316.1a] **Online filing:** The application may be filed online, and the filing fee paid by credit card, at the Department's Self Service Portal (*https://docqnet.dfpi.ca.gov*).

(2) [5:316.2] **"Small company application for permit":** A "small company" making an offering pursuant to a "Small Corporate Offering Registration" (SCOR) disclosure document (based on Form U-7 adopted by the North American Securities Administrators Association) may file for a permit under Corps.C. § 25113(b)(2). This alternative to the standard application was enacted primarily to allow smaller issuers engaged in a multistate offering to use the streamlined NASAA U-7 format in preparing both the disclosure document and the permit application.

An issuer may use the "small company" permit procedure if it meets all of the following conditions (¶ 5:316.2 ff.):

(a) [5:316.3] **Issuer qualifications:** It is either:

• a California corporation, or

• a foreign corporation subject to Corps.C. § 2115 ("pseudo-foreign corporation," *¶ 3:5*);

and it is *not:*

• a "reporting company" under the 1934 Act,

• an investment company under the Investment Company Act of 1940 (but federal law now preempts qualification of investment company securities; *see ¶ 5:18.5 ff.*),

• an oil-and-gas or mining exploration or development company, *or*

• a "blind pool" company (i.e., a "blank check" company, *¶ 5:110*). [Corps.C. § 25113(b)(2)(A); see Commr. Rule 260.113.1(b)]

(b) [5:316.4] **Common vs. preferred stock:** Though an issuer may use the "small company" permit procedure to sell common or preferred stock (or a combination of the two), immediately after the sale and issuance it can have only one class of *voting common* stock. [Corps.C. § 25113(b)(2)(B)]

(c) [5:316.4a] **$1 million offering limit:** The aggregate offering price of the stock being qualified, together with *any other securities* issued concurrently or within the prior 12 months, cannot exceed $1 million. [Corps.C. § 25113(b)(2)(B)]

(d) [5:316.5] **$2 per share minimum price:** The offering price must be *at least $2 per share*. If preferred stock convertible into voting common is being sold, the conversion price must likewise be *at least $2 per share*. [Corps.C. § 25113(b)(2)(C)]

(e) [5:316.5a] **Two-year moratorium on transactions affecting capital structure:** The issuer must file an undertaking with the Financial Protection and Innovation Commissioner to forgo stock splits, stock dividends, spinoffs and mergers for two years after the offering. (Notwithstanding such an undertaking, the Commissioner may approve a spinoff or merger pursuant to an application for qualification.) [Corps.C. § 25113(b)(2)(C)]

(f) [5:316.6] **Use of proceeds:** All of the net proceeds from the offering must be expended in *operations of the business*. [Corps.C. § 25113(b)(2)(D)]

Proceeds may *not* be used to service or repay any debt or make any payment (other than reasonable salaries) to any officer, director, 10% shareholder or affiliate. [Commr. Rule 260.113.1(b)]

(g) [5:316.7] **Contents of disclosure document:** The offering must be made with a disclosure document based on the NASAA's Form U-7, prepared in conformity with additional requirements prescribed by the Commissioner (see Commr. Rule 260.113.1(b)). [Corps.C. § 25113(b)(2)(E)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(*Note:* Although specifically authorized by Corps.C. § 25113(b)(2)(E) to adopt investor suitability and due diligence investigation requirements, the Commissioner has not yet done so expressly with reference to the small company application procedure. Nevertheless, the Commissioner may impose investor suitability requirements indirectly by granting only a "limited" permit; *see ¶ 5:321*.)

Form: The Small Corporate Offering Registration form (Form U-7) may be obtained online at the NASAA's website (*www.nasaa.org*).

(h) [5:316.8] **Execution by majority of directors:** Both the application for permit and the disclosure document must be reviewed and signed by a majority of the issuer's directors. [Corps.C. § 25113(b)(2)(F)]

(i) [5:316.9] **Filing fee:** The filing fee for a small company application for permit is $2,500, subject to an additional charge of up to $1,000 to cover the costs of processing the application (i.e., salary or other compensation paid to the persons processing the application plus overhead costs reasonably incurred in performing the work). Where the costs exceed the filing fee, the Commissioner requires the applicant to submit the full $1,000 before continuing to process the application; any unexpended fee will be refunded. [Corps.C. § 25608(e); Commr. Rule 260.110]

[5:316.10 - 5:316.14] ***Reserved.***

(3) [5:316.15] **"Small business issuer" application for permit:** The Commissioner has adopted a modified permit application process for "small business issuers" that seek to raise *no more than $5 million* in a public offering.

If the "small business issuer" meets the conditions specified below (¶ 5:316.16 ff.), various of the merit review "fairness" standards (*¶ 5:318 ff.*) are greatly relaxed (*see ¶ 5:316.19 ff.*).

(a) [5:316.16] **Issuer qualifications:** A "small business issuer" is any entity that meets *all* of the following qualifications:

- It has annual revenues of *less than $12.5 million;*

- It is *either* (i) a California corporation, (ii) a foreign corporation subject to Corps.C. § 2115 (i.e., a "pseudo-foreign corporation," *¶ 3:5 ff.*), or (iii) a foreign corporation having California shareholders owning at least 25% of its outstanding shares and having a combined California property, payroll and sales factor for the latest full income year of at least 25% (provided that the payroll factor is at least 50%);

- It is neither a blind pool nor an investment company subject to the Investment Company Act of 1940 (but federal law now preempts state qualification requirements for investment company securities; *see ¶ 5:18.5 ff.*); and

- If it is a majority-owned subsidiary, its parent must also be a "small business issuer." [Commr. Rule 260.001(i)]

(b) [5:316.17] **Investor suitability standards:** The offering must be limited to:

- Investors who have purchased no more than *$2,500* of the securities within 12 months (with spouses counted as one individual); and/or

- Investors having a minimum net worth (excluding home, furnishings and cars) of $150,000—or, alternatively, $75,000 *and* minimum gross income of $50,000 during both the prior and current tax years—*provided* that under either alternative the purchase does not exceed 10% of the investor's net worth. [Commr. Rule 260.140.01(e)]

(c) [5:316.18] **Guidebook delivery requirement:** At least five business days before accepting a prospective investor's offer to purchase securities, the issuer must deliver a copy of "A Consumer's Guide to Small Business Investments," prepared by the North American Securities Administration Association. [Commr. Rule 260.140.05(c)]

(d) [5:316.19] **Merit standards relaxed:** A "small business issuer" whose offering satisfies the above requirements (¶ 5:316.15) is subject to relaxed standards when applying for a permit:

1) [5:316.20] **Business plan:** The issuer's business plan will *not* be subject to the feasibility standards (¶ 5:323). [Commr. Rule 260.140.01(e), 260.140.05]

2) [5:316.21] **Promotional shares:** If the issuer also meets the conditions for filing a permit application under the SCOR program (*¶ 5:316.2 ff.*), up to 50% of its stock may be issued as promotional shares. [Commr. Rule 260.140.31(b); *see ¶ 5:329 ff.*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

3) [5:316.22] **Pricing of securities:** Though the purchase price must be at least $2 per share, the price is not otherwise subject to “fairness review” (*¶ 5:322*). [Commr. Rule 260.140.01(e)]

4) [5:316.23] **Selling expenses:** Selling expenses of up to 18% of the aggregate offering price (20% where the offering does not exceed $3 million) are presumed reasonable; *see ¶ 5:342.1*. [Commr. Rule 260.140.20(b), (c)]

5) [5:316.24] **Financial statements:** A “small business issuer” need provide financial statements for only *two* fiscal years (unlike the three years generally required for other issuers). Where the offering amount and all other securities sales within the preceding 12 months do not exceed $500,000, the financial statements need be only *reviewed* (rather than audited) by an independent public accountant. [Commr. Rule 260.613(a) &(f); *see ¶ 5:342.5 ff.*]

b. [5:317] **Discretion of Department of Financial Protection and Innovation Commissioner:** The Financial Protection and Innovation Commissioner may refuse to issue a permit unless they find that the proposed plan of business of the applicant *and* the proposed issuance of securities are “*fair, just and equitable*,” that the applicant intends to transact its business “fairly and honestly,” and that the securities which it proposes are not such as, in their opinion, “will work a fraud” upon the purchaser thereof. [Corps.C. § 25140(b)]

c. [5:318] **Standards for granting or refusal of permit:** The Financial Protection and Innovation Commissioner has promulgated certain guidelines for the exercise of their discretion in granting or refusing to issue a permit. However, these guidelines do not preclude application of more lenient, or more stringent, standards in particular cases. [Commr. Rule 260.140]

➪ [5:319] ***PRACTICE POINTER:*** In practice, more lenient standards are often applied in the case of “limited” (nonpublic) offerings. Indeed, imposition of many of the restrictive conditions discussed below may be relaxed if *all* of the proposed investors make a *written request* to this effect, and the Commissioner is satisfied they are capable of evaluating the risks involved, and that they have made an informed judgment.

(1) [5:320] **“Seasoned” vs. “unseasoned” businesses:** For certain purposes, businesses are classified as “seasoned” or “unseasoned.” A “seasoned” business is one that has been in bona fide operation (either through the present corporation or a predecessor) for *at least two years*, and has been profitable in at least one of the past three fiscal years. [Commr. Rule 260.001(g)]

In general, the Financial Protection and Innovation Commissioner is inclined to apply the standards more stringently where an “unseasoned” business is applying for a permit to issue securities.

(2) [5:321] **“Open” vs. “limited” permits:** It is generally difficult for an unseasoned corporation to obtain an open qualification (permitting it to sell its securities to the public at large). More lenient standards are imposed where an unseasoned corporation seeks permission to sell to a limited number or group of persons.

(a) [5:322] **Review of selling price:** To be qualified, securities must be sold at a price fair to both the issuer and purchasers. In determining fairness of the selling price, the Commissioner primarily looks to the following factors:

- If securities of the same class are publicly traded on an active market of substantial depth, the recent market price of such securities; or

- If there is no public market, the price of securities of reasonably comparable corporations in the same industry (with appropriate adjustments for dissimilarities);

- If neither of the above situations applies, the earnings record, book value and prospects of the issuer in light of existing general market conditions are considered;

- Finally, in an initial public offering, the initial selling price may not be less than $2 per share. [Commr. Rule 260.140.50]

1) [5:322.1] **Compare—“small business issuer”:** Issuers qualifying for the “small business issuer” permit application (*¶ 5:316.15 ff.*) are subject to only the *last* of the above four factors (¶ 5:322) (i.e., the $2 per share minimum selling price). [Commr. Rule 260.140.01(e); *see ¶ 5:316.22*]

(3) [5:323] **Feasibility of business plan:** The business plan's feasibility is of primary concern in deciding whether an “open” permit will be granted. A business is deemed too speculative for an open permit if it is not likely to show a profit within a reasonable period of time. Twenty-four months is presumptively reasonable, but a longer time may be allowed in light of the “nature and circumstances” of the proposed business, including any industry-wide “operational norms.” [Commr. Rule 260.140.05(a)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

The Commissioner may also require the issuer to retain an independent public accountant to review financial statements and forecasts contained in the business plan. [Commr. Rule 260.140.05(b)]

(a) [5:323.1] **Waiver for "small business issuer":** These requirements regarding feasibility of business plan do not apply to issuers qualifying for the "small business issuer" permit application (*¶ 5:316.15 ff.*). [Commr. Rule 260.140.01(e); *see ¶ 5:316.20*]

(4) Capital structure

(a) [5:324] **Seasoned businesses:** There is generally no problem where a seasoned corporation proposes to issue just common stock. But if it proposes to issue senior securities (preferred or debt) which are neither participating nor convertible on a fair basis, the corporation must show its ability to meet the dividend, interest or sinking fund requirements … both for the securities proposed to be issued, *and* for all existing senior securities outstanding. The issuer's ability is determined from its previous earnings history "or demonstrated future earning or cash-flow capacity." [Commr. Rule 260.140.10]

(b) [5:325] **Unseasoned businesses:** An unseasoned corporation may be granted an "open" permit to issue *common stock* (so that all shareholders bear the same risk). Moreover, an open permit may be granted to issue preferred stock or debt if they are *convertible* into common, or otherwise are *participating* (as to dividends, etc.) and non-redeemable.

[5:326] But an open permit will generally *not* be approved for an unseasoned corporation to sell preferred stock or debt securities that are nonparticipating and nonconvertible on some fair basis (public holders would not have fair chance at profits). An unseasoned corporation *may* be permitted to sell such securities, however, to its existing common stockholders on a pro rata basis or "if the circumstances otherwise justify." [Commr. Rule 260.140.9]

(5) [5:327] **Restrictions on transfer:** An "open" permit will not be granted if the shares to be issued are subject to transfer restrictions in the articles or bylaws. Limited offering permits may be granted for issuance of shares subject to such restrictions … provided they do not "unfairly prejudice" the holder's ability to resell and are otherwise "reasonable" under the Commissioner's criteria. [Commr. Rule 260.140.8]

[5:328] *Reserved.*

(6) [5:329] **Limitations on promotional shares:** Promotional shares are not ordinarily allowed in financing a "seasoned" corporation, but a reasonable amount of promotional stock is allowed in financing *unseasoned* corporations. *Up to 25%* of the total stock issuance (*50%* in the case of a "small business issuer" meeting the requirements of a SCOR permit application, *see ¶ 5:316.21*) is *presumptively* "reasonable." [Commr. Rule 260.140.31]

(a) [5:330] **"Promotional shares":** This includes stock issued for *services rendered* in organizing the corporation; or shares issued for *assets not having a determinable market value* (e.g., patents, copyrights, "know-how," goodwill). [Commr. Rule 260.140.30]

Moreover, shares issued to a "promoter" of the corporation at a price substantially lower than that which others are paying for similar shares, are treated as "promotional shares" (and hence subject to the 25%/50% limit). [Commr. Rule 260.140.30]

(b) [5:331] **Waiver of dividends, assets on liquidation or preferences:** Normally, promotional shares will be issued only upon condition that the holders waive all rights to dividends (cash or property), or to participate in any distribution of assets in the event of liquidation. Moreover, such shares must have no greater preference (as to voting rights, etc.) than the shares issued for cash. [Commr. Rule 260.140.32, 260.141]

(c) [5:332] **Restrictions on transfer; legend on share certificates:** Normally, promotional share certificates must carry a bold legend as follows:

> "THE SHARES REPRESENTED BY THIS CERTIFICATE ARE SUBJECT TO CERTAIN RESTRICTIONS, INCLUDING WAIVERS OF DIVIDENDS AND ASSETS; AND IT IS UNLAWFUL TO CONSUMMATE A SALE OR TRANSFER OF THEM, OR ANY INTEREST THEREIN, OR RECEIVE ANY CONSIDERATION THEREFOR, WITHOUT THE PRIOR WRITTEN CONSENT OF THE COMMISSIONER OF FINANCIAL PROTECTION AND INNOVATION [FORMERLY THE

COMMISSIONER OF BUSINESS OVERSIGHT] OF THE STATE OF CALIFORNIA." [Commr. Rule 260.141.1; *see* ¶ *5:458*]

➪ [5:333] ***PRACTICE POINTER:*** The Financial Protection and Innovation Commissioner may be willing to waive the various restrictions on promotional shares (i.e., the 25%/50% limit, the waiver of dividends, etc.) if *all proposed shareholders so request in writing*. The restrictions above (¶ 5:329) are intended for the protection of the other shareholders. Therefore, if the Commissioner is satisfied that they have been *informed* as to all material facts, and that they are *capable* of evaluating the merits of the matter, their wishes will normally be respected.

(7) [5:334] **Limitations on outstanding stock options, warrants, rights:** Various standards apply, depending on the type of stock option, warrant or other purchase right. However, the total number of shares called for by all outstanding options or rights (excluding pro rata options to existing shareholders, and certain warrants to debt holders or accompanying stock purchases; ¶ 5:335 ff.) *may not exceed a number equal to 30%* of the outstanding shares (excluding shares subject to promotional waivers) *unless* a higher percentage is approved by at least two-thirds of the outstanding shares entitled to vote. [Commr. Rule 260.140.45(a)]

(a) [5:335] **Options to employees:** Employee stock options are presumptively reasonable if issued under employee stock option plans or employee stock purchase plans that meet the criteria specified in Rules 260.140.41 ("Compensatory Option Plans") and 260.141.42 ("Compensatory Purchase or Bonus Plans Excluding Option Plans"), respectively.

(b) [5:336] **Pro rata options to existing shareholders:** Pro rata options to existing shareholders are presumed reasonable provided they (1) expire within 90 days after issuance; (2) are freely transferable; and (3) have an exercise price which is not so low in relation to the value of the shares (as calculated under Rule 260.140.50, ¶ *5:322*) to unreasonably prejudice those shareholders who are unable to exercise or sell their option rights. [Commr. Rule 260.140.40]

1) [5:336.1] **Presumption of reasonableness:** An exercise price not more than 15% below the value of the shares (as calculated under Rule 260.140.50) is presumed reasonable. However, such options must not unfairly prejudice the *relative* equity positions of different classes of outstanding shares. [Commr. Rule 260.140.40]

2) [5:336.2] **Caution re below-market options:** Below-market options have adverse tax consequences under IRC § 409A and are generally no longer granted. [See R. Olshan and E. Schohn, *Section 409A Handbook* 14-15 to 14-20 (2nd ed., Bloomberg 2016)]

(c) [5:337] **Warrants to holders of debt securities:** Stock purchase warrants granted to holders of debt securities are presumed reasonable if they expire before maturity of the debt or within 15 years, whichever is less; and the exercise price is not lower than the market price of the stock at the time the warrants are granted. [Commr. Rule 260.140.43]

(d) [5:338] **Warrants accompanying stock purchases:** Warrants granted to purchasers of equity securities are presumed reasonable if their issuance is necessary to secure additional equity financing; their term does not exceed 5 years; the number of shares issuable under the warrants does not exceed the number purchased; and the exercise price is equal to the market value of the security at the time the warrants are granted. [Commr. Rule 260.140.44]

(e) [5:339] **Options to underwriters:** Stock options granted to underwriters are presumed reasonable if:

— they do not exceed 10% of the underwritten shares;

— they expire within five years;

— either the exercise of the options, or the resale, transfer and assignment of the underlying shares, is prohibited for at least one year after the offering; *and*

— the exercise price is at least 20% more than the public offering price (or it may be equal to the public offering price the first year and increase by 7% each subsequent year). [Commr. Rule 260.140.21]

(f) [5:340] **Exception for Rule 701 plans:** The 30% limitation on total outstanding options or rights (¶ *5:334*) does not apply to a compensatory benefit plan or agreement that complies with SEC Rule 701 (¶ *5:189.1 ff.*). [Commr. Rule 260.140.45(c)]

(8) [5:341] **Limitations on selling expenses:** Selling expenses in connection with the share issuance should not exceed the amounts "reasonably necessary" for the sale and issuance. Expenses up to 15% of the aggregate offering price are

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

presumed reasonable. (The 15% is computed on the portion of the aggregate offering price actually received by the issuer.) [Commr. Rule 260.140.20(a)]

(a) [5:342] **"Selling expenses":** This includes underwriting and brokerage discounts and commissions (including fees of the underwriters' attorneys paid by the issuer), plus expenses incurred in connection with qualifying, registering and selling the securities (e.g., expenses relating to printing, mailing, engineers and other experts, trustees, transfer agents, depositories and salaries of employees while engaged in sales activity).

However, "selling expenses" do *not* include the issuer's own attorneys' and accountants' fees, or the value of options granted to the underwriters. [Commr. Rule 260.140.20(a)]

(b) [5:342.1] **Compare—"small business issuer":** For an issuer selling up to $5 million of securities under the "small business issuer" permit application process (*¶ 5:316.15 ff.*), selling expenses up to *18%* of the aggregate offering price are presumed reasonable, provided the total underwriting and brokerage discounts and commissions do not exceed 13% of the aggregate offering price. [Commr. Rule 260.140.20(b)]

If the offering does not exceed *$3 million*, selling expenses of up to *20%* are presumed reasonable, provided the total underwriting and brokerage discounts and commissions do not exceed 15%. [Commr. Rule 260.140.20(c)]

[5:342.2 - 5:342.4] ***Reserved.***

(9) [5:342.5] **Financial statements:** As a general rule, the issuer must furnish financial statements for its three most recent fiscal years, including a balance sheet current to within 90 days prior to the date of the permit application. If the application is for an *open* qualification (*¶ 5:321*), the financial statements must be audited. [Commr. Rule 260.613(a) & (b)]

However, recognizing that many new businesses might not have a three-year operating history and that preparation of audited financial statements may present a financial hardship, the Commissioner may relax these requirements and even waive the requirement of audited financials. (Conversely, the Commissioner may require audited financial statements when appropriate in *limited* offerings.) [Commr. Rule 260.613(c)]

(a) [5:342.6] **Relaxed requirements for "small business issuer":** A "small business issuer" (*¶ 5:316.15 ff.*) need provide financial statements for only *two* fiscal years. And where the offering amount and all other securities sales within the preceding 12 months do not exceed $500,000, the financial statements need be only *reviewed* (rather than audited) by an independent public accountant. [Commr. Rule 260.613(a) & (f)]

(10) [5:343] **Other standards relating to rights of security holders:** The Commissioner's Rules set forth a number of detailed guidelines to protect purchasers of the securities sought to be issued. The most important of these are:

• [5:344] Common stock voting rights. [Commr. Rule 260.140.1]

• [5:345] Voting rights for preferred stock if dividends in arrears. [Commr. Rule 260.140.2; *see ¶ 3:128*]

• [5:346] Other protective provisions for preferred shares (minimum priorities and preferences). [Commr. Rule 260.140.3; *see ¶ 3:126*]

• [5:347] Protective rights for debt securities (sinking fund requirements, etc.). [Commr. Rule 260.140.4; *see ¶ 3:69 ff.*]

• [5:348] Limitation on assessability of securities. [Commr. Rule 260.140.7; *see ¶ 4:106*]

• [5:349] Antidilution provisions to protect conversion rights of convertible securities. [Commr. Rule 260.140.6; *see ¶ 3:130*]

d. [5:350] **Permit may be granted conditionally:** To assure that the share issuance is "fair, just and equitable," the Financial Protection and Innovation Commissioner may (and often does) impose conditions in granting the permit. [Corps.C. § 25141]

(1) [5:351] **Waiver of rights on promotional shares:** As mentioned earlier, a permit to issue promotional shares will ordinarily be granted upon condition that the holders *waive* all rights to dividends or assets upon liquidation; *see ¶ 5:331*.

(2) [5:352] **Impound conditions:** Unless the offering is firmly underwritten (rare with small issues), the Commissioner may impose an impound condition, the effect of which is to prevent the issuer from spending any of the money raised by share issuance until *all* (or a specified percentage) of the shares are sold. [Commr. Rule 260.141.21]

(a) [5:353] Such impound condition normally will be required if the Commissioner finds that a specific minimum amount of money is necessary to finance the business plan described in the application and that it is "inadvisable" for the corporation to proceed until that minimum amount is raised. [Commr. Rule 260.141.20]

(b) [5:354] A depository (local bank) is generally required to receive and hold all funds raised until the Commissioner finds that sufficient shares have been sold and orders the funds released. [Commr. Rule 260.141.23 and 260.141.24]

(3) [5:355] **Transfer restrictions:** Where the Commissioner has approved some variation from the guidelines normally applicable, and determines that, as a result of such variation, there is a risk that further transfers of the shares might be "unfair, unjust or inequitable," the Commissioner may require that their approval be obtained before any such transfer. [See Commr. Rule 260.141.10]

In such event, the restriction must be imprinted on the share certificates, as discussed at *¶ 5:454*.

(4) [5:356] **Escrow conditions:** The Commissioner may also condition a permit on the shares being placed in escrow (to prevent transfer, etc.). [Corps.C. § 25141]

However, this is no longer common. Instead, transfer restrictions are imposed by legend condition upon the share certificates; see ¶ 5:355.

➪ [5:357] ***PRACTICE POINTER:*** Again, if all of the affected parties so request in writing, the Commissioner may be persuaded to relax or waive the imposition of any of the foregoing conditions, if satisfied the parties have made an informed judgment on the matters involved. [See Commr. Rule 260.140, 260.141.10]

[5:357.1 - 5:357.4] ***Reserved.***

e. [5:357.5] **Commissioner's authority to monitor issuer and revoke permit:** The Commissioner may "examine" the issuer to review compliance with the permit conditions and other applicable law. The Commissioner may "disqualify" the offering (i.e., revoke the permit) if they find that the issuer has *materially violated* the permit provisions. [Corps.C. § 25113(e)]

f. [5:357.6] **Required semi-annual reports for 18 months following qualification:** An issuer that is selling securities pursuant to an *open* qualification (¶ 5:321) and that is not filing reports pursuant to SEA §§ 13 or 15(d) must file semi-annual financial reports with the Commissioner within 120 days after the end of its fiscal year and within 90 days after the end of the first six months of its fiscal year. The reports must be filed until the expiration of 18 months after the qualification became effective. [Corps.C. § 25146; Commr. Rule 260.146]

(1) [5:357.7] **Contents:** The report filed as of the end of a fiscal year must contain a balance sheet as of that date and a profit and loss statement for the year then ended, covered by an auditor's report containing an unqualified opinion of an independent public accountant. [Commr. Rule 260.146]

The report filed as of the end of the first six months of a fiscal year must contain a balance sheet as of that date and a profit and loss statement for the six-month period then ended. These financial statements need not be audited but must be prepared in accordance with GAAP. [Commr. Rule 260.146]

4. [5:358] **Enforcement Provisions:** The Corporate Securities Law contains civil remedies, criminal sanctions and administrative enforcement actions. All such remedies are *cumulative*, so that a single violation may result in a variety of enforcement actions. Moreover, the civil remedies are in addition to whatever other remedies or causes of action the injured party may have under other statutes or common law (e.g., common law fraud). [Corps.C. § 25510; *Bowden v. Robinson* (1977) 67 CA3d 705, 711, 136 CR 871, 876]

a. [5:358.1] **Effect of choice of law and forum selection clauses; waiver:** A person acquiring a security through an offering or sale that is subject to the California Corporate Securities Law cannot contractually waive compliance with the law's requirements. [Corps.C. § 25701; *Hall v. Sup.Ct. (Imperial Petroleum, Inc.)* (1983) 150 CA3d 411, 418-419, 197 CR 757, 762-763; *see* ¶ 5:195.1 ff. (California Corporate Securities Law's scope)]

Accordingly, a choice of law or forum selection clause in any contract for the purchase of securities in California is not enforceable unless it applies California law or the chosen law or selected forum "provides the same or greater rights than California." The party seeking to enforce the foreign choice of law or forum selection clause bears the burden of showing that "enforcement will not in any way diminish the plaintiff's unwaivable statutory rights." [See *Verdugo v. Alliantgroup, L.P.* (2015) 237 CA4th 141, 157, 187 CR3d 613, 626 (reaffirming *Hall* and applying it to wage and hour lawsuit based on Labor Code); *Swipe Acquisition Corp. v. Krauss* (Del. Ch. 2021) 2021 WL 282642, *2-3, *8 (unpub.opn.)—plaintiff did not waive California Securities Law claim by agreeing to Delaware choice of law provision]

b. [5:359] **Statutory liability for violation of qualification requirements:** Failure to comply with applicable qualification requirements renders the transaction *voidable* at the option of the purchaser. Any such violation, no matter how inadvertent, entitles the purchaser to rescind and be made whole, or to obtain damages for any loss sustained on the investment. [Corps.C. § 25503]

All that need be shown is that the securities in question were issued in violation of applicable qualification requirements (Corps.C. §§ 25110, 25120, 25130 or 25133; *see ¶ 5:195a ff.*), or of some condition of qualification imposed by the Financial Protection and Innovation Commissioner (Corps.C. § 25141; *see ¶ 5:350*).

An offer or sale is treated as *unqualified* if it is conducted in a manner that varies from or exceeds the scope of (1) any material *term or condition* of the qualification (as set forth in the permit or other qualification order) or (2) any material representation as to the *manner of offering* contained in the *application* for qualification. [Corps.C. § 25110]

(But violations that occur in an offer or contract of sale are disregarded if, prior to the payment or receipt of any consideration for the securities, the sale is qualified with the Financial Protection and Innovation Commissioner; see Corps.C. § 25503, last sent.)

(1) [5:360] **Who may sue:** Liability is limited to "the person acquiring" the securities in the transaction that violated the qualification requirements. [Corps.C. § 25503]

(a) [5:361] **Original purchasers:** Thus, only the original purchaser may sue for rescission or damages based on the issuer's failure to qualify nonexempt securities at the time of issuance, or to comply with some condition on qualification imposed by the Financial Protection and Innovation Commissioner. [See *Bowden v. Robinson* (1977) 67 CA3d 705, 712, 136 CR 871, 876]

(b) [5:362] **Compare—subsequent purchasers:** Subsequent purchasers cannot sue the issuer for rescission or damages based on violations at the time of issuance (because they were not "the person acquiring the securities" within the meaning of Corps.C. § 25503).

But they may have a cause of action against whomever sold them the shares (either the original purchaser or some later owner) if that sale violated qualification requirements for "nonissuer" transactions under § 25130; or was made in violation of some escrow condition or legend restriction imposed by the Financial Protection and Innovation Commissioner under § 25141. [Corps.C. § 25133]

(2) [5:363] **Scope of recovery:** The purchaser is entitled to be made whole. They are entitled to whichever of the following is applicable:

(a) [5:364] **Rescission:** If the purchaser still owns the security, and tenders it back to the issuer before judgment, the purchaser is entitled to the consideration paid for such security, plus interest at the legal rate, less the amount of any income received therefrom. [Corps.C. § 25503]

If the consideration paid is incapable of being returned (e.g., shares issued in exchange for property which has been sold or consumed by the corporation), the purchaser is entitled to recover the *value* of such consideration, plus interest at the legal rate. [Corps.C. § 25503]

1) [5:364.1] **Rescissionary damages against control persons and aiders/abettors?** In cases decided under Corps.C. § 25501, courts disagree whether a purchaser who continues to own worthless securities is limited to the remedy of rescission that can be asserted against only an actual seller. *See ¶ 5:395.1 ff.*

(b) [5:365] **Damages:** If the purchaser no longer owns the security, they obviously cannot obtain rescission. In such cases, the purchaser is entitled to damages. The amount recoverable is the difference between (a) the price paid or value of noncash consideration given for the security, *plus interest* at the legal rate from date of purchase and (b) the value of the security at the time it was disposed of by the plaintiff, plus any income received therefrom by plaintiff. [Corps.C. § 25503]

(c) [5:365.1] **No offset for tax benefits:** Damages are not reduced by any tax benefits received by the plaintiffs, since this would result in the government bearing the cost of defendants' fraud. [*Danzig v. Jack Grynberg & Assocs.* (1984) 161 CA3d 1128, 1139, 208 CR 336, 343]

(*Compare—federal law:* This issue is not fully resolved in suits for out-of-pocket damages under the federal securities laws; *see ¶ 5:71.3*.)

(d) [5:366] **No punitive damages:** Punitive damages are not recoverable in an action for rescission or damages for violation of qualification requirements. [See *Bowden v. Robinson* (1977) 67 CA3d 705, 714, 136 CR 871, 878, involving action for statutory liability for misrepresentations]

➪ [5:367] ***PRACTICE POINTER:*** If you represent the plaintiff, consider joining a cause of action for common law fraud, which would give you a basis for claiming punitive damages.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Even if there has been no actual misrepresentation, you may be able to base a fraud count on the failure to qualify the issue. Although the matter is unsettled, it can be argued that every sale of a security carries with it an *implied representation* that a permit (where required) has been secured. [See *Bowden v. Robinson* (1977) 67 CA3d 705, 717, 136 CR 871, 879, fn. 1; *and* ¶ *5:425*]

(e) [5:367.1] **Attorney fees:** In addition to rescission (¶ 5:364) or damages (¶ 5:365), a purchaser is also entitled to reasonable attorney fees. [Corps.C. § 25503]

(3) [5:368] **Who may be held liable:** The following persons are *jointly* and *severally* liable for violations of applicable qualification requirements:

(a) [5:369] **Issuer:** The issuer, or any other person *on whose behalf* the offering or sale was made. [Corps.C. § 25503]

1) [5:369.1] **Issuer absolutely liable:** The issuer or person on whose behalf the shares were sold is absolutely liable, so that even innocent, inadvertent violations entitle the purchaser to rescind or seek damages. There need be no showing of fraud or material misstatements or omissions. All that need be shown is violation of applicable qualification requirements. [Corps.C. § 25503; and see *Walton v. Anderson* (1970) 6 CA3d 1003, 1009, 86 CR 345, 349—"Even good faith … would not be a defense in an action to recover the purchase price paid for shares sold without, or in advance of, authorization in the form of a permit"]

(b) [5:370] **Underwriter:** The underwriter of the securities offering is also liable even for inadvertent violations. (This is true whether the underwriting was on a firm commitment or "best efforts" basis.) [Corps.C. § 25503]

1) [5:371] **Limitation on liability:** However, the underwriter's liability is limited to the total price of the securities underwritten … *unless* it knowingly received from the issuer (directly or indirectly) some benefit for underwriting the issue in which other underwriters did not share proportionately (i.e., a "lead" underwriter). [Corps.C. § 25503]

(c) [5:372] **Persons vicariously liable because of relationship to violator:** In addition, the following are *jointly and severally liable* because of their relationship to the violator:

• [5:373] **"Control parties":** Every person who directly or indirectly controls the violator. [Corps.C. § 25504; see Corps.C. § 25403(a)]

• [5:374] **Partners:** Every partner of a partnership which is the violator. [Corps.C. § 25504]

• [5:375] **Executive officers, directors:** Every principal executive officer or director of a corporate violator, and "every person occupying a similar status or performing similar functions." [Corps.C. § 25504]

• [5:376] **Employees, broker-dealers:** Every *employee* of a violator, and every *broker-dealer or agent*, who "*materially aids*" in the transaction constituting the violation. [Corps.C. § 25504]

1) [5:377] **"Due diligence" defense available:** Persons other than the issuer or person on whose behalf the sale was made, may rely on "due diligence" as a defense—i.e., they may avoid personal liability by showing they had "no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability is alleged to exist." [Corps.C. § 25504]

Thus, the vicarious liability sought to be imposed on persons solely because of their relationship with the issuer can be avoided by showing they had no actual knowledge or reason to be suspicious regarding the facts constituting the qualification violation.

For example, officers, directors and employees of a corporate issuer are not personally liable for issuing stock in violation of qualification requirements, if they had reasonable grounds to believe the issuance was *exempt* (e.g., that the offering was limited to less than 35 purchasers all of whom had pre-existing relationships with the issuer, and hence the issue was exempt under Section 25102(f)).

(d) [5:377.1] **Aiders and abettors:** Further, even without any relationship to the violator (as above, ¶ 5:377), a person who "*materially assists*" *in the violation* "*with intent to deceive or defraud*" is jointly and severally liable. [Corps.C. § 25504.1; see Corps.C. § 25403(b); *and* ¶ *5:408 ff.*]

1) [5:377.2] **Scienter required:** As noted above, scienter is not a requirement for liability against the issuer or those vicariously liable because of their relationship to the issuer. But it is a requirement as to other persons sought to be held liable as "aiders and abettors." [See Corps.C. § 25504.1; *and* ¶ *5:409*]

[5:377.3 - 5:377.5] ***Reserved.***

(e) [5:377.6] **Rescissionary damages available against control persons and aiders/abettors?** Courts are divided on whether persons other than securities sellers can be liable, jointly and severally with sellers, for rescissionary damages to a purchaser whose securities have become worthless. *See ¶ 5:363 ff., 5:394 ff.*

(4) [5:378] **Indemnification and contribution among defendants:** If the violation was merely *inadvertent*, everyone liable (¶ 5:377.6) must share the liability; i.e., each has a right of contribution against the others based upon their respective shares of the total liability. [Corps.C. § 25505]

But "*willful*" violators are not entitled to contribution from violators who were merely negligent.

And, if a corporation is held liable because of "willful violations" by any of its officers, directors or "controlling persons," the *corporation* is entitled to indemnification from each such "willful" violator. [Corps.C. § 25505] (But any suit for such indemnification must be brought within one year after final judgment against the corporation; see Corps.C. § 25508.)

(5) [5:379] **Duration of liability:** When violations occur in the sale or issuance of securities, the issuer remains exposed to a purchaser's suit for rescission until the statute of limitations has run (¶ 5:380), or it makes a statutory offer to repurchase the securities (¶ 5:386 ff.).

(a) [5:380] **Statute of limitations:** A relatively short statute of limitations applies to actions for qualification violations: Any such action must be commenced within *one year* after *discovery* of the facts constituting the violation, and in no event later than *two years* after such violation. [Corps.C. § 25507(a)]

1) [5:381] **Effect:** The practical effect of the above statute of limitations (¶ 5:380) is that the company cannot be sure, for up to two years after issuing its securities without qualification, that it won't have to refund its entire capitalization.

It also gives the purchasers one or two years to reevaluate the investment, during which they have an absolute right to rescind (*¶ 5:364*). If the business is doing well, they can stay in; but if its prospects are less than expected, they can get their money back … i.e., a free "second look" at whether or not to invest.

2) [5:382] **"Discovery of the facts constituting the violation":** The one-year limitations period runs from the time plaintiff *actually* (not should have) learned the facts constituting the violation—e.g., the fact that the securities sale occurred in California, that it was not qualified, and that no exemption was available. In other words, plaintiff has *no duty to exercise due diligence* to determine that the issuance of the securities was unlawful. [*Eisenbaum v. Western Energy Resources, Inc.* (1990) 218 CA3d 314, 325, 267 CR 5, 11-12; compare *Deveny v. Entropin, Inc.* (2006) 139 CA4th 408, 423, 427-430, 42 CR3d 807, 817, 821-824—"inquiry notice" rather than actual notice triggers Corps.C. § 25506(b) limitations period for misrepresentation (*¶ 5:414.1*) and market manipulation (*¶ 5:419.13*)]

• [5:382.1] In connection with selling P a limited partnership interest, D, the general partner, claims the transaction is exempt under federal and California securities laws when it is not. Since P has no actual knowledge that the sale to him is unlawful, the one-year statute does not begin to run until he *actually* discovers the transaction's illegality. [See, e.g., *Eisenbaum v. Western Energy Resources, Inc.* (1990) 218 CA3d 314, 325, 267 CR 5, 12—1-year limitations period commenced when P's attorney told him, contrary to seller's representations, that security purchase not exempt; but also see *Deveny v. Entropin, Inc.* (2006) 139 CA4th 408, 422, 42 CR3d 807, 817 (characterizing *Eisenbaum* court's interpretation of Corps.C. § 25507(a) as dicta)]

3) [5:383] **Fraudulent concealment as extending statute:** The two-year period is *not* extended by claims that the defendant "fraudulently concealed" the violations and thereby prevented discovery of the cause of action. (E.g., P claims D fraudulently failed to disclose a permit was required to issue the shares, thereby inducing P to retain the shares past the time for rescinding the sale.)

Reason: The statute of limitations on qualification violations is deemed to be "an integral part of the cause of action" itself so that "the right, as well as the remedy, is extinguished upon expiration of the limitation" period. [See *Bowden v. Robinson* (1977) 67 CA3d 705, 713, 136 CR 871, 877]

4) [5:384] **Fraudulent representations as extending statute:** However, if the issuer falsely represents that a permit *has been obtained*, the longer statute applicable to misrepresentations applies (up to five years; see Corps.C. § 25506(b), *¶ 5:414*).

The fact that the alleged misrepresentation was with respect to qualification does *not* subject the claim to the shorter statute governing qualification violations. [*Bowden v. Robinson* (1977) 67 CA3d 705, 717, 136 CR 871, 879]

[5:385] ***Reserved.***

(b) [5:386] **Effect of repurchase offers:** The issuer can drastically shorten the period during which purchasers can change their minds, by offering to repurchase their shares in accordance with Corps.C. § 25507(b)-(d). Purchasers who fail to accept such an offer, within the time provided therein, are *barred* thereafter from suing to rescind or for damages. [Corps.C. § 25507(b)]

1) [5:387] **Contents:** The offer must be in a form approved by the Corporations Commissioner (see ¶ 5:388), and must contain the following provisions:

• Disclosure of the facts constituting the violation (e.g., the failure to obtain a permit, the lack of any applicable exemption, etc.);

• Offer to rescind the share issuance, by putting the purchasers back in the same position as before the transaction; *or* to pay damages or repurchase the shares for cash in the amount that would be recoverable in an action under Corps.C. § 25503 (*see ¶ 5:363*);

• Give the purchaser at least 30 days after receipt to accept the offer (unless the purchaser earlier rejects the offer);

• The statutory provisions governing such repurchase offers (§ 25507(b)); and

• Such other information as the Commissioner may require by rule or order. [Corps.C. § 25507(b)]

2) [5:388] **Application for approval by Financial Protection and Innovation Commissioner:** The form and contents of the repurchase offer must be approved in advance by the Financial Protection and Innovation Commissioner on a prescribed form. [Corps.C. § 25507(b); Commr. Rule 260.507]

• ***FORM:*** The Commissioner's form, Application for Approval as to Form of Offer to Repurchase a Security Under Subdivision (b) of Section 25507 of the Corporate Securities Law of 1968 (Form DBO-260.507), may be filled in and downloaded from the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

a) [5:388.1] **Consent to service of process:** If the issuer has not previously filed a formal consent to service of process, it must do so in connection with its application for approval. [Corps.C. § 25507(d)]

b) [5:388.2] **Online filing:** The application may be filed online at the Department's Self Service Portal (*https://docqnet.dfpi.ca.gov*).

3) [5:389] **Conditions:** By rule or by order, the Commissioner may impose any or all of the following conditions if they find that it is "necessary and appropriate for the protection of investors":

• That equivalent and concurrent offers to repurchase be made to all investors to whom liability may have arisen and still exist in connection with the same distribution or transaction;

• That the offer contain a provision that it shall be void if the issuer, by reason of accepting such offers, is "disabled from commencing or continuing in business" (i.e., so that the purchasers will be free to sue others);

• That the offer be made within a specified period after approval by the Commissioner;

• That a purchaser's rejection of the offer will not bar suit if made on the ground that the amount tendered by the issuer is less than that which the purchaser is entitled to recover under Corps.C. § 25503 (¶ *5:363*);

• That the offeror file a report or reports with the Commissioner stating the progress and results of the offer and compliance with any of the above conditions imposed. [Corps.C. § 25507(c)]

[5:389.1 - 5:389.5] ***Reserved.***

(6) [5:389.6] **Effect of federal preemption of qualification requirement:** As stated earlier (¶ 5:18.5 ff.), federal law preempts state law qualification requirements for specified securities and/or transactions. Thus, there can be no Corps.C. § 25503 liability for failure to qualify a "preempted" security or transaction. [SA § 18(a), (b)(4) (15 USC § 77r(a), (b)(4))]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

However, failure-to-qualify liability can be avoided on the ground of preemption only if the security or transaction *actually meets* the preemption requirements. Defendant's *claim* that the security or transaction is preempted does *not* preclude plaintiff from maintaining an action for failure to qualify. (Such a claim is an *affirmative defense* as to which defendant bears the burden of proof.) [*Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 249-252, 70 CR3d 199, 218-220; *Brown v. Earthboard Sports USA, Inc.* (6th Cir. 2007) 481 F3d 901, 909-912; see *Consolidated Mgmt. Group, LLC v. Department of Corporations* (2008) 162 CA4th 598, 608, 75 CR3d 795, 804—Commissioner validly issued "desist and refrain" order (*see* ¶ *5:429*) enjoining offers that relied on preemption but did not comply with its requirements]

(a) [5:389.7] **Example—reliance on Rule 506 (Reg. D):** Offers or sales of securities exempt from federal registration because made in reliance on the SEC Rule 506 private placement exemption (¶ *5:172 ff.*) are "preempted" and hence need not be qualified. [SA § 18(b)(4)(F) (15 USC § 77r(b)(4)(F)); *see* ¶ *5:18.6*]

But to be preempted, the offers and sales *must have met the Rule 506 requirements*. The fact that defendant offered and sold the securities "in reliance on" Rule 506 does not avoid Corps.C. § 25503 failure-to-qualify liability if the reliance was unjustified. [*Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 248-252, 70 CR3d 199, 218-220; see *Brown v. Earthboard Sports USA, Inc.* (6th Cir. 2007) 481 F3d 901, 911-912; *Consolidated Mgmt. Group, LLC v. Department of Corporations* (2008) 162 CA4th 598, 608, 75 CR3d 795, 804]

c. [5:390] **Statutory liability for misrepresentation:** The remedies under Corps.C. § 25503 (¶ 5:359 ff.) apply only where qualification requirements were violated—i.e., in nonexempt transactions. However, the Corporate Securities Law also imposes liability for *misrepresentations* (*misstatements* or *omissions* of *material* facts) in connection with an offer or sale of a security, *whether or not qualification is required*—i.e., even if the transaction is *exempt* from qualification. [Corps.C. § 25401; *People v. Smith* (1989) 215 CA3d 230, 236-237, 263 CR 684, 687; see Corps.C. § 25400(d)]

Patterned after a portion of SEA § 10(b) and SEC Rule 10b-5 (¶ *6:360 ff.*), Corps.C. § 25401 provides:

> "It is unlawful for any person to offer or sell a security in this state, or to buy or offer to buy a security in this state, by means of any written or oral communication that includes an untrue statement of a material fact or omits to state a material fact necessary to make the statements made, in the light of the circumstances under which the statements were made, not misleading." [Corps.C. § 25401]

Persons who violate § 25401 are expressly made liable to the person purchasing such securities for rescission or damages. [Corps.C. § 25501]

This statutory liability is in *addition* to any other civil liability that may exist; e.g., *common law* fraud or negligent misrepresentation; *see* ¶ *5:358*.

[5:391] ***Reserved.***

(1) [5:392] **Who may sue—"privity" required:** Only the *original purchaser (or seller)* of the security may recover for misrepresentation in connection with the original issuance of a security. The Code specifically provides that the defendant is liable "to the person who *purchases* a security *from him* or *sells* a security *to him* …" [Corps.C. § 25501 (emphasis added); see *Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 252-253, 70 CR3d 199, 221 (*discussed at* ¶ *5:399.1*); also see *Bains v. Moores* (2009) 172 CA4th 445, 479, 91 CR3d 309, 337; *California Amplifier, Inc. v. RLI Ins. Co.* (2001) 94 CA4th 102, 109, 113 CR2d 915, 921]

(a) [5:393] **Compare—subsequent purchasers:** Subsequent purchasers cannot recover under Corps.C. § 25501 for misrepresentations in connection with the original issuance. But they may have other remedies: e.g., if they purchased in reliance on inaccurate information contained in the offering circular or memorandum, the accountant, appraiser or engineer responsible therefor may be held liable. [See Corps.C. § 25504.2, ¶ *5:410*]

(b) [5:393.1] **Compare—administrative enforcement action seeking restitution:** The privity requirement does not apply in an administrative enforcement action brought by the Financial Protection and Innovation Commissioner, who may seek restitution or damages on behalf of *any person* injured by the misrepresentation. [Corps.C. § 25530(b); *People ex rel. DuFauchard v. O'Neal* (2009) 179 CA4th 1494, 1503-1504, 102 CR3d 573, 579-580; *see* ¶ *5:430c*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [5:394] **Scope of recovery:** As where liability is based on qualification violations (¶ *5:363 ff.*), purchasers are entitled to be "made whole." If they *still own* the security, they are entitled to *rescind* the purchase and recover the consideration paid. If they *no longer own* the security, they are entitled to *damages*. [Corps.C. § 25501; see *Viterbi v. Wasserman* (2011) 191 CA4th 927, 935, 123 CR3d 231, 236]

Moreover, if the shares have not yet been issued, plaintiff can tender a release of their *equitable* interest in the stock and rescind the sale under § 25501. [*Bowden v. Robinson* (1977) 67 CA3d 705, 718, 136 CR 871, 880]

(a) [5:395] **Rescission:** Where the purchaser still owns the security, they may tender the security (at any time before entry of judgment) and recover the consideration paid therefor, plus interest at the legal rate, less the amount of any income received on the security. [Corps.C. § 25501]

1) [5:395.1] **Rescissionary damages against control persons and aiders/abettors?** Courts are divided on whether a purchaser can obtain rescission against a defendant who did not own or sell the security:

• [5:395.2] One case held that the remedy of rescission may not be invoked against control persons, aiders/abettors or other persons who assisted or were involved in the transaction but who did *not actually own or sell* the security. [*Viterbi v. Wasserman* (2011) 191 CA4th 927, 935-943, 123 CR3d 231, 236-242—defendant who "never owned the securities, did not sell them to plaintiffs, and did not receive money from plaintiffs … cannot return money she never received or rescind a transaction to which she was not a party"]

• [5:395.3] But a later case expressly disagrees: The Legislature, in enacting the provisions of Corps.C. §§ 25504 and 25504.1 that impose liability on "secondary" actors *jointly and severally with sellers* (¶ *5:401 ff.*), intended to depart from the requirement of contractual "privity" between plaintiff and secondary actors. "If the relief that would be available from the primary actor under section 25501 would be rescission and the return of money owing to the plaintiff, then the person who is secondarily liable is liable for the money required to make the plaintiff whole, even if he or she may not be capable of actual rescission because he or she was not a party to the contract." [*Moss v. Kroner* (2011) 197 CA4th 860, 875-879, 129 CR3d 220, 229-232]

a) [5:395.4] **Comment:** *Moss*, supra, is the better-reasoned decision. As noted in *Moss*, the result in *Viterbi*, supra, is inequitable and contrary to the intention of the Corporate Securities Law, because "the victims who are most severely damaged by misrepresentations or fraud about a security—those whose holdings are valueless and untransferable—possess fewer remedies than those who suffer less severe injury and have a security that can be transferred." In such circumstances, *Viterbi* reads Corps.C. §§ 25504 and 25504.1 out of the Corporate Securities Law insofar as they apply to secondary violators. [See *Moss v. Kroner* (2011) 197 CA4th 860, 876, 879, 129 CR3d 220, 230, 232]

(b) [5:396] **Damages:** Purchasers are entitled to the same damages as where liability is based upon qualification violations—i.e., the amount paid, plus interest at the legal rate from date of purchase, less any amounts received from the security (¶ *5:365*). [Corps.C. § 25501; see *Boam v. Trident Fin'l Corp.* (1992) 6 CA4th 738, 743-744, 8 CR2d 177, 180-181—plaintiff has absolute right to interest under § 25501]

1) [5:396.1] **Compare—aggrieved seller's damages:** Where misrepresentations induced the *sale* of a security, the seller is entitled to recover the difference between (i) the value of the security at the time the seller filed their *complaint* (or *cross-complaint*, as the case may be) plus any amounts received by the buyer from the security and (ii) the sale price received by the seller plus interest at the legal rate from the date of sale. [Corps.C. § 25501; see *Zalkind v. Ceradyne, Inc.* (2011) 194 CA4th 1010, 1032-1039, 124 CR3d 105, 120-125—seller who sought damages by way of cross-complaint could not claim higher damages calculated by "relating back" to date of filing of purchaser's complaint]

a) [5:396.2] **Rescission available:** The plaintiff seller may elect to rescind the sale and recover the security from the purchaser (if the purchaser still owns the security) upon the seller's tender of the consideration received, plus interest at the legal rate, less any amounts defendant (purchaser) received from the security. [Corps.C. § 25501; see *Zalkind v. Ceradyne, Inc.* (2011) 194 CA4th 1010, 1041-1042, 124 CR3d 105, 126-128—rescission not available where defendant purchaser resold security and plaintiff seller could not return consideration received from purchaser (assets of purchaser's company that were largely integrated into and consumed by plaintiff's business)]

(c) [5:397] **No punitive damages:** "Punitive damages are not available to those who choose to proceed under the above corporate misrepresentation statute rather than under a common law fraud action." [*Bowden v. Robinson* (1977) 67 CA3d 705, 714, 136 CR 871, 878; *and see* ¶ *5:366*]

➪ [5:398] ***PRACTICE POINTER:*** Again, if you represent plaintiffs, this is a good reason to consider joinder of a cause of action for *common law* fraud, if possible (*see ¶ 5:367*).

(d) [5:398.1] **Attorney fees and costs:** In addition to rescission (¶ 5:395 ff.) or damages (¶ 5:396 ff.), a prevailing purchaser or seller who successfully establishes a right to relief is entitled to reasonable attorney fees and costs. [Corps.C. § 25501]

(3) Who may be held liable

(a) [5:399] **Violator (seller):** Under Corps.C. § 25501, any person who offers or sells (or buys) securities by means of misrepresentations may be held liable to the person who sells to or purchases "*from him* …" [Corps.C. § 25501 (emphasis added)]

1) [5:399.1] **Direct "privity" required:** Liability under Corps.C. § 25501 is thus limited to the actual seller (or purchaser) of the securities. Aiders, abettors and other persons may *not* be held liable under § 25501 (but may be liable under other Code sections; *see ¶ 5:401 ff.*). [*Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 252-254, 70 CR3d 199, 221-222]

a) [5:399.2] **Analogous federal law (SA § 12(a)(2)) distinguished:** The Corps.C. § 25401 prohibition on misrepresentations and omissions was originally derived from SA § 12(a)(2), which has been construed to impose liability on the seller *and other persons* who act on their behalf or who are vicariously liable (*see ¶ 5:68.1*, discussing *Pinter v. Dahl* (1988) 486 US 622, 647, 108 S.Ct. 2063, 2078). However, the two sections are not substantially identical. The federal statutes refer only to a "seller" without addressing the liability of participants. In contrast, the California Corporate Securities Law expressly addresses the liability of various participants (*see ¶ 5:401 ff.*). For this reason, there is no justification for imposing liability on anyone other than the direct seller (or purchaser) under Corps.C. §§ 25401 and 25501. [*Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 253-254, 70 CR3d 199, 221-222 (decided under prior version of § 25401)]

2) [5:400] **Defenses available:** Corps.C. § 25501 does not impose "strict liability." A violator may avoid liability by proving *either*:

• *Plaintiff knew* the facts concerning the alleged "untruth or omission" and was not mislead thereby; *or*

• Defendant (issuer) had exercised *reasonable care* and did not know (or in the exercise of reasonable care would not have known) of the "untruth or omission." [Corps.C. § 25501]

Hence, unlike criminal proceedings for Corps.C. § 25401 violations (*¶ 5:431.1*), defendants in civil actions may assert a "lack of knowledge" defense. [*Bowden v. Robinson* (1977) 67 CA3d 705, 715, 136 CR 871, 878; see *People v. Simon* (1995) 9 C4th 493, 517, 37 CR2d 278, 293]

(b) [5:401] **Persons vicariously liable because of relationship to violator:** In addition, the following are *jointly and severally liable* because of their relationship to the violator:

• [5:402] **"Control parties":** Every person who directly or indirectly controls the violator. [Corps.C. § 25504; see Corps.C. § 25403(a); see also *Hellum v. Breyer* (2011) 194 CA4th 1300, 1314-1317, 123 CR3d 803, 813-816—complaint survives demurrer if it adequately pleads control person had direct or indirect *power* to control violator (complaint need not plead control person actually *exercised* control)]

• [5:403] **Partners:** Every partner of a partnership which is the violator. [Corps.C. § 25504]

• [5:404] **Executive officers, directors:** Every principal executive officer or director of a corporate violator, and "every person occupying a similar status or performing similar functions." [Corps.C. § 25504; see *Hellum v. Breyer* (2011) 194 CA4th 1300, 1309-1314, 123 CR3d 803, 808-813—"the plain language of section 25504 means that principal executive officers and directors are presumptively liable for their corporation's issuance of unqualified securities, regardless of whether they participated in the transactions at issue, or controlled the issuer"]

• [5:405] **Employees, broker-dealers:** Every *employee* of a violator, and every *broker-dealer or agent*, who "*materially aids in the act or transaction constituting the violation*." [Corps.C. § 25504 (emphasis added); see *Moss v. Kroner* (2011) 197 CA4th 860, 871, 129 CR3d 220, 225-226]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Here, to be jointly and severally liable with the violator, the employee, broker-dealer or agent must have materially aided not simply in the transaction, but also *in the violation*—i.e., they must have had either knowledge or reasonable grounds to know of the *misrepresentation*. [*Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 255-256, 70 CR3d 199, 223-224]

1) [5:406] **Vicarious liability:** Such persons are liable only if the violator is itself liable; i.e., if the violator has no defense as indicated above (no due diligence). [Corps.C. § 25504]

2) [5:407] **Defense:** Such persons can avoid liability if they can show they "had no knowledge of or reasonable grounds to believe in the existence of the facts" which constitute the violation. [Corps.C. § 25504]

Thus, the vicarious liability sought to be imposed on persons solely by reason of their relationship to the violator can be avoided if they had no actual knowledge of the misrepresentation and were not aware of any suspicious circumstances.

(c) [5:408] **Aiders and abettors:** Further, even without any relationship to the violator (as above, ¶ 5:407), a person who "*materially assists" in the violation "with intent to deceive or defraud"*—i.e., with intent to *induce reliance* on the knowing misrepresentation—is jointly and severally liable. [Corps.C. § 25504.1 (emphasis added); see *Arei II Cases* (2013) 216 CA4th 1004, 1014-1015, 157 CR3d 368, 376-377; *Moss v. Kroner* (2011) 197 CA4th 860, 872, 878-879, 129 CR3d 220, 226-227, 231-232; *Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 257, 70 CR3d 199, 224-225]

1) [5:409] **Intent to defraud required:** Although fraudulent intent is not a requirement for liability against the violator or those vicariously liable because of their relationship to the violator (¶ 5:407), it *is* a requirement as to other persons sought to be held liable as "aiders and abettors." [See Corps.C. § 25504.1; *Arei II Cases* (2013) 216 CA4th 1004, 1015-1016, 157 CR3d 368, 377]

2) [5:409.1] **Direct relationship to violation required:** To be liable as an "aider and abettor," defendant must have materially assisted *in the actual securities law violation*—i.e., plaintiff must show how defendant assisted in the act of *selling or offering to sell securities by means of false and misleading statements (or omissions)*. "Such assistance may take the form of aiding in the preparation of offering documents relied upon by investors, communicating misrepresentations directly to investors, or otherwise playing a material, facilitating role in the act of selling or attempting to sell the securities by means of misrepresentations or omissions of material fact." Defendant's role in a part of the scheme that did not involve misrepresentation in the offer and sale is inadequate to establish liability. [*Arei II Cases* (2013) 216 CA4th 1004, 1014-1015, 157 CR3d 368, 376-377]

• [5:409.2] An investment bank helped arrange initial financing from institutional lenders for a real estate project that was subsequently syndicated and sold to investors (plaintiffs) by means of a private placement memorandum containing material misrepresentations. Even if the bank had a pivotal role in the overall "scheme" or transaction, it did *not* assist in *making the misrepresentations to plaintiffs* and hence was not liable for "aiding and abetting" the violation that formed the basis of their suit. [*Arei II Cases* (2013) 216 CA4th 1004, 1008-1009, 1018-1019, 157 CR3d 368, 371-372, 380]

3) [5:409.3] **Compare—no "substantial assistance" liability under Corps.C. § 25403:** Corps.C. § 25403 provides that any person who "knowingly provides substantial assistance to another person in violation of any provision" of the Corporate Securities Law "shall be deemed to be in violation of that provision" to the same extent as the person to whom the assistance was provided. However, the civil liability provisions of the Corporate Securities Law (Corps.C. §§ 25500-25510) do not provide a private right of action for a violation of § 25403. [See *Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 255, 70 CR3d 199, 223]

(d) [5:410] **Persons certifying information:** Under specified, limited circumstances (¶ 5:411), an accountant, engineer, appraiser, or other professional person (including a lawyer) whose authority as an expert is relied on in any offering documents by which any security is offered or sold, may be held jointly and severally liable with the issuer for misstatements or omissions therein. [Corps.C. § 25504.2]

1) [5:411] **Conditions for liability:** Such liability will be imposed only if the following circumstances are shown:

• The professional was *named* in the offering documents as one who prepared or certified some part thereof; and

• The professional gave their *written consent* to being so named, in accordance with rules adopted by the Financial Protection and Innovation Commissioner (see Commr. Rule 260.504.2.2; *and see* ¶ *5:411.1*); and

• The part of the offering documents so prepared or certified by the professional contains a *materially* false statement or omission; and

• The person suing acquired the security in reliance on such misstatements or omissions. [Corps.C. § 25504.2(a)]

a) [5:411.1] **Effect of no written consent:** Written consent to being named in the offering documents is required only when an offering is *qualified* with the Financial Protection and Innovation Commissioner.

Literally applied, this could mean a professional is not liable under Corps.C. § 25504.2 for misstatements or omissions in an offering that is *not* qualified (because written consent is *not* required).

However, an issuer's attorney may be liable where they *negligently fail* to qualify an offering required to be qualified (and thus does not file a written consent with the Commissioner) but permits their name to be used in offering documents. In such cases, the attorney's consent "is *deemed* written and filed in compliance with the Commissioner's Rules." [See *Koehler v. Pulvers* (SD CA 1985) 614 F.Supp. 829, 847]

1/ [5:411.2] **Comment:** *Koehler*'s finding of a "deemed" consent, while understandable on the facts, is contrary to the express terms of Corps.C. § 25504.2(a), and it is unlikely that other courts would follow its holding. A more appropriate focus for the type of behavior that led the court to find a "deemed consent" is § 25504.1, which holds persons who "materially" assist in misrepresenting material facts in a disclosure document, with "intent to deceive or defraud," to be jointly and severally liable with the issuer.

2) [5:412] **Defenses:** Professionals certifying information are entitled to assert a special, narrower "due diligence" defense. They can avoid liability by showing that *either:*

• They had, *after reasonable investigation*, *reasonable ground* to believe and did believe that the statements were true and that there were no misleading omissions; *or*

• The offering documents did not fairly represent the information supplied by such professional person (i.e., incorrect copies or extracts); *or*

• The professional *warned* the issuer and the *Financial Protection and Innovation Commissioner* that they were disclaiming responsibility for the information *before* the purchaser acquired the security. [Corps.C. § 25504.2(b)]

[5:412.1 - 5:412.4] ***Reserved.***

(e) [5:412.5] ***Not government entities:*** Under the California Government Claims Act (Gov.C. § 810 et seq.), California government entities (cities, counties, etc.) are immune from liability for misrepresentation, whether intentional or negligent. This immunity *overrides* any misrepresentation liability that a government entity may have under the Corporate Securities Law. [Gov.C. § 818.8; *Nuveen Municipal High Income Opportunity Fund v. City of Alameda, Calif.* (9th Cir. 2013) 730 F3d 1111, 1124-1127]

(f) [5:412.6] **Limitation—rescission only against sellers:** Although the Corporate Securities Law does not expressly so state, the joint and several liability of persons other than sellers/issuers can apply only with respect to *damages* liability. Plaintiffs who still own the securities and seek a *rescission* remedy may proceed only against the *seller*. *See* ¶ *5:394 ff.*

(4) [5:413] **Contribution among defendants:** The right of contribution among defendants for misrepresentations in the offer or sale of securities is the same as where liability is based on qualification violations. [Corps.C. § 25505; *see* ¶ *5:378*]

(5) [5:414] **Two-year/five-year statute of limitations:** An action for rescission or damages based on misrepresentation in violation of Corps.C. § 25401 must be brought within *two years* after discovery thereof, and in no event more than *five years* after the violation occurred. [Corps.C. § 25506(b)]

(a) [5:414.1] **Accrual upon inquiry notice:** Actual knowledge of a misrepresentation is not required to trigger the two-year limitations period. Rather, the limitations period commences to run when plaintiff has knowledge of *circumstances sufficient to lead a reasonably prudent person to suspect that a misrepresentation occurred.* (This is a *factual* issue for the *jury* to determine … unless the facts admit of only one conclusion as a matter of law.) [*Deveny v. Entropin, Inc.*

(2006) 139 CA4th 408, 423, 427-430, 42 CR3d 807, 817, 821-824; see *Stella v. Asset Mgmt. Consultants, Inc.* (2017) 8 CA5th 181, 191-193, 213 CR3d 850, 858-860, *discussed at* ¶ *5:415*]

(b) [5:415] **Compare—common law fraud:** A longer statute of limitations may apply on a *common law* fraud cause of action arising from a securities sale: *three years* after the sale. Under the "delayed discovery" rule, the three-year period does not begin to run until plaintiff discovers, or has reason to discover, the fraud. However, once plaintiff has a factual basis to *suspect* fraud ("inquiry notice"), they must act with *reasonable diligence* to *discover* the fraud. [CCP § 338(d); *Stella v. Asset Mgmt. Consultants, Inc.* (2017) 8 CA5th 181, 191-193, 197, 213 CR3d 850, 858-860, 863—"delayed discovery" rule did not apply where disclosure in limited partnership's private placement memorandum of commission paid to general partner on acquisition of real estate provided investor with "inquiry notice, if not actual notice" that commission may have actually been a "markup" borne by investors rather than true commission borne by real estate seller; *WA Southwest 2, LLC v. First American Title Ins. Co.* (2015) 240 CA4th 148, 156-157, 192 CR3d 423, 429-430—"delayed discovery" rule did not apply where information disclosed in private placement memorandum gave plaintiffs "inquiry notice" of falsity of any communications regarding the investment]

(c) [5:416] **Compare—qualification violations:** As discussed earlier, a shorter statute governs qualification violations: *one year* after discovery and not more than *two years* after the qualification violation (¶ *5:380*). "Recovery under the qualification-violation provisions is relatively simple and therefore justifies the shorter statute of limitations." [*Bowden v. Robinson* (1977) 67 CA3d 705, 716, 136 CR 871, 879]

(d) [5:417] **Shorter statute against professionals:** Actions against accountants, appraisers, engineers or other professionals (*see* ¶ *5:410*) must be brought within one year after discovery "or after such discovery *should have been made by the exercise of reasonable diligence*" of their misrepresentations; and in no event later than *three years* after such misrepresentations occurred. [Corps.C. § 25506.1]

(6) [5:418] **Repurchase offer no bar:** Unlike suits based on qualification violations, the issuer's offer to repurchase the securities is *not* a bar to a later suit for rescission or damages by the purchaser based on misrepresentations or omissions in the offering statement.

➪ [5:419] ***PRACTICE POINTER:*** Even so, if you represent the issuer, it is a good idea to make such an offer. It may not bar later suits by the purchasers, but it may deflate their claims as to "malice" and "intent to injure," and thus avoid a possible claim for punitive damages on a common law theory (*see* ¶ *5:420 ff.*).

[5:419.1 - 5:419.4] ***Reserved.***

d. [5:419.5] **Statutory liability for market manipulation/deception:** Corps.C. § 25400 imposes liability for various acts of *market manipulation*, such as wash sales, matched orders or rigged prices, that are intended to create a *false appearance of active trading* in a security. [Corps.C. § 25400(a)-(c), (e); see *Overstock.Com, Inc. v. Goldman Sachs & Co.* (2014) 231 CA4th 513, 528-530, 180 CR3d 269, 281-282; *Diamond Multimedia Systems, Inc. v. Sup.Ct. (Pass)* (1999) 19 C4th 1036, 1039, 80 CR2d 828, 830 & fn. 2; and *California Amplifier, Inc. v. RLI Ins. Co.* (2001) 94 CA4th 102, 108, 113 CR2d 915, 920]

It also imposes liability upon sellers or purchasers (or persons *offering* to sell or purchase) who knowingly misstate or omit material facts to *induce sales or purchases* of the security. [Corps.C. § 25400(d); see *StorMedia Inc. v. Sup.Ct. (Werczberger)* (1999) 20 C4th 449, 456-463, 84 CR2d 843, 848-852, *discussed at* ¶ *5:419.11b*]

(1) [5:419.6] **Who may sue:** *Any person* who purchases or sells a security whose price was affected by an act proscribed by Corps.C. § 25400 may recover damages. [Corps.C. § 25500; see *California Amplifier, Inc. v. RLI Ins. Co.* (2001) 94 CA4th 102, 109-110, 113 CR2d 915, 921-922]

(a) [5:419.7] **Reliance not necessary:** Plaintiff need *not* demonstrate reliance on defendant's deception or manipulation. (This makes the Corps.C. § 25400 remedy preferable to an action predicated on common law fraud or deceit; ¶ 5:420 ff.) [*Diamond Multimedia Systems, Inc. v. Sup.Ct. (Pass)* (1999) 19 C4th 1036, 1046, 80 CR2d 828, 834, fn. 11]

(b) [5:419.8] **Plaintiffs not limited to California purchasers/sellers:** Corps.C. § 25400 imposes liability for manipulative or deceptive acts performed "in this state." Availability of the § 25400 remedy does not require that the *resulting purchase or sale* take place in California. Thus, deceptive statements by securities purchasers (or sellers) made or disseminated in California may be actionable by *non-Californians* who sold (or purchased) the securities *outside California* (e.g., through the New York Stock Exchange). [Corps.C. § 25400(d); *Diamond Multimedia Systems, Inc. v.*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Sup.Ct. (Pass) (1999) 19 C4th 1036, 1064, 80 CR2d 828, 836-838; see *StorMedia Inc. v. Sup.Ct. (Werczberger)* (1999) 20 C4th 449, 456, 84 CR2d 843, 847]

Conversely, misconduct occurring entirely *outside California* is *not actionable* under § 25400. [*Overstock.Com, Inc. v. Goldman Sachs & Co.* (2014) 231 CA4th 513, 539-541, 180 CR3d 269, 289-291]

(c) [5:419.9] **Limitation—federal preclusion ("preemption") of state law class actions:** Federal law preempts certain state law securities class actions that are based on *market manipulation* or material *misstatements or omissions* in connection with securities purchases and sales. *See discussion at ¶ 6:375.5 ff.*

(2) [5:419.10] **Scope of recovery:** Plaintiff must prove "loss causation"—i.e., that the price of the securities was affected by an act proscribed by Corps.C. § 25400. Damages are equal to the difference between the purchase/sale price and the market value that the securities would have had at the time of the purchase/sale in the absence of the proscribed act. Plaintiff is also entitled to interest at the legal rate from the date of the purchase/sale. [Corps.C. § 25500; *OCM Principal Opportunities Fund v. CIBC World Markets Corp.* (2007) 157 CA4th 835, 883, 68 CR3d 828, 871, fn. 32]

(a) [5:419.10a] **Applicability of federal standard for loss causation:** If California law provides limited guidance on how the "loss causation" element should be applied in a particular case, a court may look to federal law, which is "'unusually strong persuasive precedent' in construing" Corps.C. §§ 25400 and 25500. [*Irving Firemen's Relief & Retirement Fund v. Uber Techs., Inc.* (9th Cir. 2021) 998 F3d 397, 405-406 (quoting *Kamen v. Lindly* (2001) 94 CA4th 197, 203, 114 CR2d 127, 132); *see* ¶ 6:373d ff.]

(3) [5:419.11] **Who may be held liable:** Liability may be imposed on "any person who willfully participates in any act or transaction in violation of Section 25400." [Corps.C. § 25500 (emphasis added)]

(a) [5:419.11a] **High level of scienter required:** Plaintiff must prove defendant acted *intentionally* with the *intent to defraud*. Liability will not be imposed for merely negligent or even reckless conduct. [See *California Amplifier, Inc. v. RLI Ins. Co.* (2001) 94 CA4th 102, 112, 117, 113 CR2d 915, 923, 927; *Kamen v. Lindly* (2001) 94 CA4th 197, 206-208, 114 CR2d 127, 134-135—director who merely signed Form 10-K containing false financial information not liable (no "willful participation" in wrongdoing)]

(b) [5:419.11b] **Conduct prohibited:** Liability may be imposed only upon a defendant who *bought* or *sold* (or *offered* to buy or sell) a security. A person who engaged in market manipulation/deception under § 25400, but who did not attempt market transactions, is not liable. [*Murphy v. BDO Seidman, LLP* (2003) 113 CA4th 687, 705-706, 6 CR3d 770, 784-785; *StorMedia Inc. v. Sup.Ct. (Werczberger)* (1999) 20 C4th 449, 456-463, 84 CR2d 843, 848-852; *Kamen v. Lindly* (2001) 94 CA4th 197, 206, 114 CR2d 127, 134]

However, liability does not require that defendant have an intent or purpose to induce a *particular* person to buy or sell securities. Moreover, liability may lie even where there is no "open" market for the securities (i.e., stock not traded on Nasdaq or an exchange). [*StorMedia Inc. v. Sup.Ct. (Werczberger)*, supra—issuer that offered and sold stock under employee stock purchase plan may be liable for engaging in "manipulation" that induced third parties to purchase stock in market transactions]

(c) [5:419.11c] **Liability of brokerage and clearing firms under § 25400(b):** Section 25400(b) makes it unlawful to "effect," alone or with one or more other persons, a series of transactions in any security creating actual or apparent active trading, or raising or depressing the price of the security, for the purpose of inducing others to purchase or sell the security. The word "effect" can include *execution, clearing and settlement* activities by brokerage and clearing firms —i.e., "effect" is not limited to the activity of the "beneficial" purchasers and sellers (the firms' clients for whom the purchases and sales were made). [*Overstock.Com, Inc. v. Goldman Sachs & Co.* (2014) 231 CA4th 513, 532, 180 CR3d 269, 284]

However, the threshold for liability is high. Brokerage and clearing firms do not incur liability under § 25400(b) for providing normal clearing services. Rather, they must engage in conduct akin to *directing* the client's manipulated trading, or *deciding with the client* how to engage in the unlawful trading, or *intentionally providing* a specialized tool for the client to engage in unlawful trading. [*Overstock.Com, Inc. v. Goldman Sachs & Co.*, supra, 231 CA4th at 538-539, 180 CR3d at 289]

(4) [5:419.12] **Contribution and indemnification among defendants:** The rights of indemnification and contribution among defendants are the same as where liability is based on Corps.C. § 25401 misrepresentation or Corps.C. § 25503 qualification violations. [Corps.C. § 25505; *see* ¶ *5:378*]

(5) [5:419.13] **Two-year/five-year statute of limitations:** As with actions predicated on Corps.C. § 25401 misrepresentation, an action for damages based on Corps.C. § 25400 market manipulation or deception must be brought within *two years* after discovery of the facts constituting the violation, and in no event more than *five years* after the manipulative or deceptive acts. [Corps.C. § 25506(b); *see ¶ 5:414*]

e. [5:420] **Compare—common law liability:** The liabilities imposed by the Corporate Securities Law are in *addition* to any common law liability arising out of the same transaction (*see ¶ 5:358*), which may include:

(1) [5:421] **Negligent misrepresentation:** A cause of action for negligent misrepresentation may lie where plaintiff shows the offering contained *material factual misstatements* (or omissions) made *without reasonable basis*.

In addition, plaintiff must prove the misstatements were *intended to induce purchases of the securities*; plaintiff *reasonably relied* upon the misstatements with no knowledge of their falsity; and the misstatements *caused* plaintiff's damages. [See *Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 243, 70 CR3d 199, 213; *Anderson v. Deloitte & Touche LLP* (1997) 56 CA4th 1468, 1476-1479, 66 CR2d 512, 516-518; *Murphy v. BDO Seidman, LLP* (2003) 113 CA4th 687, 702-703, 6 CR3d 770, 782—“indirect” reliance actionable where defendants *had reason to know* misrepresentations to *third persons* would be conveyed to plaintiffs; also see *Small v. Fritz Companies, Inc.* (2003) 30 C4th 167, 174, 132 CR2d 490, 494]

(a) [5:421a] **Misrepresentation actionable where shareholder induced not to sell:** At common law, a misrepresentation is actionable if it induces plaintiff to act *or refrain from acting* to their detriment. Thus, a common law fraud (*¶ 5:423*) or negligent misrepresentation cause of action may be predicated on misrepresentations by a corporation or its officers or directors that induce a *shareholder* to *refrain from selling their shares*. [*Small v. Fritz Companies, Inc.* (2003) 30 C4th 167, 171, 174-175, 132 CR2d 490, 492, 494-495; see *Murphy v. BDO Seidman, LLP* (2003) 113 CA4th 687, 701-702, 6 CR3d 770, 781]

1) [5:421b] **Pleading reliance—specificity required:** A stockholder alleging a misrepresentation that induced them *not* to sell securities must plead and show specific *actions*, as distinguished from unspoken and unrecorded thoughts and decisions, indicating plaintiff *actually relied* on the misrepresentations. For example, plaintiff must aver that had they read a truthful account of the corporation's financial status, plaintiff would have sold the stock, stating *when* and *how many* shares would have been sold. [*Small v. Fritz Companies, Inc.* (2003) 30 C4th 167, 171, 183-184, 132 CR2d 490, 492, 502-503; see *Murphy v. BDO Seidman, LLP* (2003) 113 CA4th 687, 702, 6 CR3d 770, 781-782]

2) [5:421c] **Compare—personal reliance not required in derivative action:** A stockholder's failure to plead or show actual reliance will preclude recovery in an *individual or class action* for fraud or misrepresentation that induced them to refrain from selling securities. However, a stockholder need *not* show personal reliance to bring a *derivative* action against the officers and directors for harm that the misrepresentation caused to the *corporation*. [*Small v. Fritz Companies, Inc.* (2003) 30 C4th 167, 184-185, 132 CR2d 490, 503; *see discussion of derivative actions at ¶ 6:602 ff.*]

3) [5:421d] **Compare—Rule 10b-5 cause of action:** In contrast to common law negligent misrepresentation, liability under SEC Rule 10b-5 requires an actual *purchase or sale* of securities. Rule 10b-5 does not allow recovery for mere inaction or forbearance. *See ¶ 6:372 ff.*

[5:421e - 5:421g] ***Reserved.***

(b) [5:421h] **Misleading statements and “half-truths” actionable:** Negligent misrepresentation requires a “positive assertion”—an “implied” assertion or representation is not adequate. “Generally, parties cannot read something into a neutral statement in order to justify a claim for negligent misrepresentation.” [*OCM Principal Opportunities Fund v. CIBC World Markets Corp.* (2007) 157 CA4th 835, 854, 68 CR3d 828, 847 (brackets and internal quotes omitted)]

Nevertheless, when defendant purports to convey the “whole truth” about a subject, misleading “half-truths” may constitute positive assertions for the purpose of negligent misrepresentation. [*OCM Principal Opportunities Fund v. CIBC World Markets Corp.*, supra]

• [5:421i] Thus, an offering memorandum's statements that crucial fourth-quarter sales exceeded the prior quarter's sales were misleading: The statements, though accurate in themselves, failed to disclose that the fourth quarter figures were significantly overstated due to “channel stuffing”—unusually large shipments of product made on consignment with the knowledge that a substantial portion would be returned unsold. [*OCM Principal Opportunities Fund v. CIBC World Markets Corp.* (2007) 157 CA4th 835, 854-855, 68 CR3d 828, 847-848]

(c) [5:421.1] **Scienter not required:** Though plaintiff must prove defendant made the misstatements with the intent to induce plaintiff to purchase the securities (*¶ 5:421*), plaintiff need *not* prove *scienter* or an *intent to deceive* or even *knowledge of falsity*. Indeed, liability for negligent misrepresentation may lie where defendant honestly believed the misstatements were true. [*Small v. Fritz Companies, Inc.* (2003) 30 C4th 167, 173, 132 CR2d 490, 494; *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 407-408, 11 CR2d 51, 74; *Apollo Capital Fund LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 243, 70 CR3d 199, 213]

(d) [5:421.1a] **Limitation—reliance not presumed ("fraud on the market" rejected):** A cause of action for negligent misrepresentation (or deceit, *¶ 5:423*) requires *actual reliance* upon the misrepresentation. Reliance may *not* be presumed from defendant's "fraud on the market"—i.e., the securities' market price was affected by defendant's misstatements or omissions and plaintiff bought or sold in reliance on the "integrity" of the market (*¶ 6:372.7*). [*Mirkin v. Wasserman* (1993) 5 C4th 1082, 1088, 23 CR2d 101, 103 (*discussed further at ¶ 6:372.7b*); see *Small v. Fritz Companies, Inc.* (2003) 30 C4th 167, 179-180, 132 CR2d 490, 499]

(e) [5:421.2] **Attorneys' and accountants' liability:** Ordinarily, attorneys, accountants and other professionals owe a *duty*, and hence may be liable, only to *clients*.

However, professionals may also owe a duty to those they *knowingly influence on their clients' behalf*. Thus, liability for negligent misrepresentation may be imposed upon attorneys, accountants and other professionals who *know with substantial certainty* that *investors* will rely upon their opinion letters, audit reports, reviews, etc. prepared and distributed in connection with the offering. [*Murphy v. BDO Seidman, LLP* (2003) 113 CA4th 687, 694-695, 6 CR3d 770, 775-776; *Anderson v. Deloitte & Touche LLP* (1997) 56 CA4th 1468, 1477, 66 CR2d 512, 516-517; see *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 408, 11 CR2d 51, 74; *Nutmeg Secur., Ltd. v. McGladrey & Pullen* (2001) 92 CA4th 1435, 1441-1448, 112 CR2d 657, 662-667]

1) [5:421.3] **Professional "opinions" treated as facts:** An essential element of the tort of negligent misrepresentation is a misstatement of *fact* (*see ¶ 5:421*). A report prepared by an accountant or other professional is frequently couched as an "opinion." Such an "opinion" may be regarded as a *positive assertion of fact* (rather than a "casual expression of belief") when based upon special expertise, knowledge or information that an investor will reasonably rely upon. The issue is then whether the person's preparation of the report fell below the *applicable standard of care* for the profession. [*Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 408, 11 CR2d 51, 74; *Anderson v. Deloitte & Touche LLP* (1997) 56 CA4th 1468, 1476-1477, 66 CR2d 512, 516; *Roberts v. Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 111, 128 CR 901, 906]

(f) [5:422] **Compare—issuers' and sellers' statutory liability:** As against issuers, control parties, executive officers, directors, employees and broker-dealers, statutory liability under Corps.C. §§ 25501 or 25504 (*¶ 5:399 ff.*) is much easier to establish than a cause of action for negligent misrepresentation, because:

• No proof of reliance is required;

• Although the fact misrepresented or omitted must be "material," no proof of causation is required; and

• Plaintiff need not prove defendant's negligence. [*Bowden v. Robinson* (1977) 67 CA3d 705, 715, 136 CR 871, 878; see *Atari Corp. v. Ernst & Whinney* (9th Cir. 1992) 981 F2d 1025, 1030—reliance element of misrepresentation claim defeated by plaintiff's knowledge that financial statements were seriously inaccurate]

(2) [5:423] **Fraudulent misrepresentation:** A cause of action for common law fraud (deceit) may also lie for *deliberate* misstatements (or omissions) made in connection with the offering. The elements of fraud are (a) a false statement or omission of a material fact, (b) knowledge of the falsity, (c) intent to defraud (i.e., to induce reliance), (d) justifiable reliance, and (e) resulting damage. [*Small v. Fritz Companies, Inc.* (2003) 30 C4th 167, 173, 132 CR2d 490, 494; *Arei II Cases* (2013) 216 CA4th 1004, 1021-1022, 157 CR3d 368, 382; *Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 240, 70 CR3d 199, 210]

(a) [5:423.1] **"Materiality":** A fact is "material" if there is a *substantial likelihood* that, under all the circumstances, a *reasonable investor would consider it important in reaching an investment decision*. Materiality is an issue for the *jury* to decide (unless only one conclusion can be reasonably drawn from the evidence). [*Persson v. Smart Inventions, Inc.* (2005) 125 CA4th 1141, 1163, 23 CR3d 335, 352]

[5:423.2] ***Reserved.***

(b) [5:423.3] **"Knowledge of falsity" synonymous with "scienter":** As stated above (*¶ 5:423*), defendant's knowledge of the falsity of the misstatement (or omission) is a necessary element of fraud. Courts have equated "knowledge of falsity" with "scienter"; hence, cases discussing "scienter" under federal securities laws may be relevant in determining "knowledge of falsity" under common law fraud. [See *Bains v. Moores* (2009) 172 CA4th 445, 454-458, 91 CR3d 309, 317-320 & fn. 11]

1) [5:423.4] **Example—suspicious stock sales in market manipulation case:** Following federal court precedents concerning SEC Rule 10b-5 fraud actions (*see ¶ 6:371.8*), corporate directors' large stock sales at propitious times *might* be evidence the directors *knew* the corporation's revenues were inflated. [*Bains v. Moores* (2009) 172 CA4th 445, 458, 91 CR3d 309, 320—"we will assume that for purposes of proving fraud under California law" suspicious stock sales could evidence scienter (but finding no scienter on facts of case)]

(c) [5:423.5] **Nondisclosure or incomplete disclosure actionable as fraud:** Nondisclosure or concealment may constitute actionable fraud when a stock purchaser or seller has a *duty* to disclose, or *voluntarily represents* they will disclose, material facts about the securities and fails to do so. Actionable nondisclosure may also arise where a purchaser or seller—even if under no duty to speak—makes *partial* representations but *suppresses additional facts* that materially qualify the facts disclosed or render the disclosure likely to mislead. [*Persson v. Smart Inventions, Inc.* (2005) 125 CA4th 1141, 1160, 1164-1165, 23 CR3d 335, 350, 353-354—50% shareholder who promised to "paint you the truest picture possible of where the company is" when buying out other 50% shareholder committed fraud by failing to disclose promising product that subsequently generated enormous revenues; *OCM Principal Opportunities Fund v. CIBC World Markets Corp.* (2007) 157 CA4th 835, 859, 68 CR3d 828, 851]

(d) [5:423.6] **Misrepresentation actionable where shareholder induced not to sell:** *See ¶ 5:421a ff.*

(e) [5:423.7] **Limitation—reliance not presumed ("fraud on the market" rejected):** *See ¶ 5:421.1a*.

(f) [5:423.8] **Attorney liability:** A fraud action may likewise lie against an issuer's counsel who makes fraudulent statements or omissions to prospective purchasers in connection with a securities offering. "If an attorney commits actual fraud in his dealings with a third party, the fact he did so in the capacity of attorney for a client does not relieve him of liability." [*Vega v. Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 291, 17 CR3d 26, 31-32]

[5:423.9 - 5:423.12] ***Reserved.***

(g) [5:423.13] **Conspirator liability:** Liability may extend beyond those who actually made the misrepresentation to persons who *engaged in the plan or design* to commit the fraud. Plaintiff must show that the conspirators acted in concert to accomplish the fraud—i.e., they expressly or tacitly agreed to achieve it. [*Arei II Cases* (2013) 216 CA4th 1004, 1022-1025, 157 CR3d 368, 382-385; see *ESG Capital Partners, LP v. Stratos* (9th Cir. 2016) 828 F3d 1023, 1039]

Each conspirator is *jointly and severally liable* for the resulting damages regardless of the degree of their activity or relative culpability. [*Applied Equip. Corp. v. Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 511, 28 CR2d 475, 478; *Prakashpalan v. Engstrom, Lipscomb & Lack* (2014) 223 CA4th 1105, 1136, 167 CR3d 832, 858; *Favila v. Katten Muchin Rosenman LLP* (2010) 188 CA4th 189, 206, 115 CR3d 274, 287]

1) [5:423.13a] **Compare—aiding and abetting:** To assert liability for aiding and abetting a fraud, plaintiff must show defendant (i) substantially assisted or encouraged another to breach a duty, *or* (ii) substantially assisted another's tort through an independently tortious act. Either alternative requires actual knowledge of the other person's wrongful act. [*ESG Capital Partners, LP v. Stratos* (9th Cir. 2016) 828 F3d 1023, 1039]

- **Cross-refer:** Conspiracy and aiding and abetting liability are discussed in greater detail in Haning, Flahavan, Cheng & Wright, *Cal. Prac. Guide: Personal Injury* (TRG), Ch. 2 Part II.

(h) [5:423.13b] **Three-year statute of limitations:** *See ¶ 5:415.*

(i) [5:423.14] **Scope of recovery:** A victim of fraud is generally limited to *out-of-pocket* damages. The object is to restore plaintiff to the financial position they enjoyed prior to the fraudulent transaction, and thus to award the difference between the *price paid* for the securities and, where the securities are retained, their *value after the fraud is discovered*.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[Civ.C § 3343; see *OCM Principal Opportunities Fund v. CIBC World Markets Corp.* (2007) 157 CA4th 835, 870, 68 CR3d 828, 860; Rest.2d Torts § 549, Comment "c"]

1) [5:423.15] **Loss causation requirement:** Plaintiff must establish proximate causation for the purpose of showing both *entitlement* to damages and the *amount* of damages. Thus, plaintiff must establish a *causal link* between the *misrepresentation or fraud* and the *decline in value* of the securities. [*OCM Principal Opportunities Fund v. CIBC World Markets Corp.* (2007) 157 CA4th 835, 869, 871-872, 875, 68 CR3d 828, 860, 862, 864; Rest.2d Torts §§ 548A, 549; see Civ.C. § 3343; *and* ¶ *6:373d ff.* re loss causation in 10b-5 cases]

Where the causal link is established, plaintiff may recover *all* out-of-pocket damages even though other factors may have contributed to the securities' decline in value (i.e., the fraud need be only "*a*"—and *not "the"*—proximate cause of the loss). [*OCM Principal Opportunities Fund v. CIBC World Markets Corp.*, supra, 157 CA4th at 873, 68 CR3d at 863; Rest.2d Torts § 549, Comment "c"]

• [5:423.16] A seller who misrepresents a corporation's financial condition is liable for the loss the purchaser sustains when the corporation's true finances become generally known and, as a result, the market value of the shares falls. But there is no liability if the stock value declines as a result of events not connected with the corporation's finances, such as the sudden death of key officers. [Rest.2d Torts § 548A, Comment "b"; see *OCM Principal Opportunities Fund v. CIBC World Markets Corp.*, supra, 157 CA4th at 872, 68 CR3d at 862]

• [5:423.17] Similarly, a shareholder induced to *retain* their bank stock by the bank president's fraudulent misrepresentation that a series of sales were bona fide transactions is not entitled to recover for depreciation in the share value due solely to the cashier's subsequent speculations. [Rest.2d Torts § 549, Comment "c"; see *OCM Principal Opportunities Fund v. CIBC World Markets Corp.*, supra, 157 CA4th at 873, 68 CR3d at 863]

• [5:423.18] *Compare:* An investor induced to buy stock because of false statements regarding the corporation's capital and assets may recover their entire loss even though the corporation's subsequent insolvency is due partly to depressed industry conditions: The corporation's chance of survival would have been greatly increased if it had the capital and assets that it was represented as having. [Rest.2d Torts § 549, Comment "c"; see *OCM Principal Opportunities Fund v. CIBC World Markets Corp.* (2007) 157 CA4th 835, 873-874, 68 CR3d 828, 863—investors induced to purchase stock by misrepresentations regarding corporation's sales and market position may recover full losses even though deterioration in market for corporation's products contributed to its collapse]

[5:423.19 - 5:423.24] ***Reserved.***

2) [5:423.25] **Includes funds expended to mitigate damages:** A defrauded investor may also recover funds reasonably expended to mitigate their damages. [*OCM Principal Opportunities Fund v. CIBC World Markets Corp.* (2007) 157 CA4th 835, 875, 68 CR3d 828, 865—investors fraudulently induced to purchase $54 million in promissory notes could also recover $2 million subsequently loaned to corporation in vain effort to forestall its collapse and preserve their investments]

(j) [5:424] **Compare—issuers' and sellers' statutory liability:** But again, liability of issuers and sellers under Corps.C. §§ 25501 or 25504 will be much easier to establish because:

• No scienter (intent to deceive or induce reliance by plaintiff) need be proved; and

• No proof of causation or reliance by plaintiff is required (see above).

(3) [5:425] **Implied misrepresentation:** Arguably, every sale of a security by an insider promoter carries with it an *implied* representation that a permit (where required) has been secured (*see* ¶ 5:384). If so, a common law fraud action could lie for every qualifications violation. [See *Mary Pickford Co. v. Bayly Brothers, Inc.* (1939) 12 C2d 501, 525, 86 P2d 102, 110]

However, the validity of this argument is doubtful under present law. [See *Bowden v. Robinson* (1977) 67 CA3d 705, 717, 136 CR 871, 879, fn. 1]

[5:425.1 - 5:425.4] ***Reserved.***

(4) [5:425.5] **Breach of fiduciary duty:** A stock purchaser's or seller's duty to disclose material facts or otherwise act in the best interests of the other party to the transaction may arise where the defendant purchaser or seller has a *fiduciary*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

or confidential relationship with the other party. However, a stock purchase or sale does *not itself* give rise to such a relationship. The existence of a confidential or fiduciary relationship is generally a *factual* issue to be determined from all of the circumstances. [See *Cleveland v. Johnson* (2012) 209 CA4th 1315, 1337-1344, 147 CR3d 772, 790-795; *Apollo Capital Fund, LLC v. Roth Capital Partners, LLC* (2007) 158 CA4th 226, 244-247, 70 CR3d 199, 214-216; *also see* *¶ 6:346* re controlling shareholder's fiduciary duty to other shareholders when transferring corporate control; compare *Persson v. Smart Inventions, Inc.* (2005) 125 CA4th 1141, 1159-1162, 23 CR3d 335, 349-351—50% shareholder did not have confidential or fiduciary relationship in arm's-length buyout of other 50% shareholder where both were represented by attorneys and accountants (but finding shareholder committed actionable fraud; *see ¶ 5:423.5*)]

(a) [5:425.5a] **Statute of limitations:** Where no fraud is alleged, a cause of action for breach of fiduciary duty must be brought within *four years* after the action accrued. The action accrues when the plaintiff beneficiary has knowledge or notice of the act constituting a breach of fidelity. In a fiduciary relationship, plaintiff is entitled to rely on the statements and advice provided by the fiduciary, and hence plaintiff's burden of discovering the fraud is reduced. However, plaintiff has a duty to *inquire* once they have knowledge of facts constituting the breach. [CCP § 343; *WA Southwest 2, LLC v. First American Title Ins. Co.* (2015) 240 CA4th 148, 157, 192 CR3d 423, 430—breach of fiduciary duty action not timely where brought more than 4 years after private placement memorandum disclosed facts giving plaintiffs notice of potential claim; see *Stella v. Asset Mgmt. Consultants, Inc.* (2017) 8 CA5th 181, 191-193, 197, 213 CR3d 850, 858-860, 863, *discussed at ¶ 5:415*; *Eisenbaum v. Western Energy Resources, Inc.* (1990) 218 CA3d 314, 324, 267 CR 5, 11]

1) [5:425.5b] **Compare—action against attorney:** An action for breach of fiduciary duty against an attorney for *violation of a professional obligation arising in the course of providing professional services to plaintiff* is subject to the CCP § 340.6 statute of limitations (one year after plaintiff discovered or through the exercise of reasonable diligence should have discovered the facts constituting the wrongful act or omission, but not more than four years from the date of the wrongful act or omission). [CCP § 340.6; see *ESG Capital Partners, LP v. Stratos* (9th Cir. 2016) 828 F3d 1023, 1036-1037]

➪ [5:425.6] ***PRACTICE POINTER:*** Even though a common law cause of action against issuers/sellers is more difficult to establish than a statutory action, there may be tactical advantages to joining a negligent misrepresentation or fraud count wherever possible:

First, there is the possibility of recovering *punitive damages* if “malice” can be shown. Such damages are not recoverable at all in an action under the Corporate Securities Law (*see ¶ 5:366*).

Second, a longer statute of limitations is usually available in a common law fraud action (*see ¶ 5:415*) and defendant cannot shorten the statute through a repurchase offer, as it can under the Corporate Securities Law (*see ¶ 5:386*).

[5:425.7 - 5:425.9] ***Reserved.***

f. [5:425.10] **No liability under Unfair Competition Law (Bus. & Prof.C. § 17200 et seq.):** Bus. & Prof.C. § 17200 et seq., which provides various remedies for “any unlawful, unfair or fraudulent business act or practice,” does *not* apply to securities transactions. Legislative intent in enacting the Unfair Competition Law was to protect consumers from unethical business practices resulting in relatively small commercial injuries; there was no intent to supplant or add to the field of securities regulation and to the remedies available to defrauded purchasers and sellers under existing state and federal securities laws. [*Bowen v. Ziasun Technologies, Inc.* (2004) 116 CA4th 777, 786-790, 11 CR3d 522, 529-533 (action alleging conspiracy among issuers and brokers to promote sale of worthless stocks)]

(1) [5:425.11] **Comment:** Subsequent courts have called into question the reach of the holding in *Bowen*, supra, and have limited *Bowen* to actions based on deceptive conduct in the *sale and purchase* of securities. [See *In re Charles Schwab Corp. Secur. Litig.* (ND CA 2009) 257 FRD 534, 552-553—*Bowen* “does not encompass all situations where securities are somehow implicated but not purchased or sold”; *Overstock.com, Inc. v. Gradient Analytics, Inc.* (2007) 151 CA4th 688, 714-716, 61 CR3d 29, 50-52 & fn. 20—*Bowen* does not extend to fraudulent transactions having indirect impact on market price of publicly traded securities; see also *Rose v. Bank of America, N.A.* (2013) 57 C4th 390, 399, 159 CR3d 693, 701, fn. 8]

g. [5:426] **Administrative and civil proceedings by Financial Protection and Innovation Commissioner and Attorney General:** The Financial Protection and Innovation Commissioner and the California Attorney General each have broad powers to enforce the Corporate Securities Law by administrative and civil proceedings. (Although these powers are

concurrent, they are to be exercised *without duplication of effort* by the Commissioner and Attorney General.) [See Stats. 2003, Ch. 876, §§ 15, 16]

(1) [5:427] **Investigations:** First of all, the Commissioner and Attorney General may conduct public or private investigations, within California or elsewhere, to determine whether any person has violated, or is about to violate, the Corporate Securities Law or any of the Commissioner's Rules or orders thereunder. [Corps.C. § 25531(a); Gov.C. §§ 12657(a), 12659(a)]

(a) [5:427.1] **Subpoena power:** In connection with such investigations, the Commissioner and Attorney General are empowered to issue subpoenas to compel the attendance of witnesses, the production of books and records, etc. [Corps.C. § 25531(c); Gov.C. § 12659(c); see *People ex rel. Owen v. Media One Direct LLC* (2013) 213 CA4th 1480, 1483, 153 CR3d 636, 639; *Tom v. Schoolhouse Coins, Inc.* (1987) 191 CA3d 827, 830, 236 CR 541, 543—Commissioner can compel disclosure of names and addresses of "customers" suspected of being "investors" in unqualified securities]

(b) [5:427.2] **Immunity from self-incrimination:** No person is excused from testifying or producing any document or other evidence before the Commissioner or Attorney General, or from complying with any subpoena, on the ground the testimony or evidence may tend to be incriminatory or subject them to a penalty. But no individual may be prosecuted as a result of such testimony or document if, after invoking the privilege against self-incrimination, they are *compelled* to testify or produce evidence. [Corps.C. § 25531(e); Gov.C. § 12659(e)]

An individual can be so *compelled* only by *order* made after a *superior court hearing* (Gov.C. §§ 11181, 11188). Absent a court order, testimony or evidence given before the Commissioner or Attorney General does *not* activate the statutory immunity from prosecution … and hence may be used to incriminate the individual. [*People v. Pappalardo* (1993) 12 CA4th 1723, 1727-1729, 16 CR2d 512, 514-515]

(c) [5:427.3] **Criminal penalties for falsification or concealment:** Any person who *knowingly and willfully* falsifies or conceals a material fact in a matter under investigation by the Commissioner or Attorney General commits a misdemeanor punishable by up to one year of imprisonment and/or a $25,000 fine. [Pen.C. § 131]

Moreover, Corps.C. § 25404 makes it unlawful to *knowingly* alter, destroy, conceal or falsify any record or document, or to make any untrue statement to the Commissioner during the course of an investigation, with the intent to impede or influence the administration or enforcement of the Corporate Securities Law. A violation of this section likewise may be punishable as a criminal offense (*see ¶ 5:431*). [Corps.C. §§ 25404, 25540(a)]

(2) [5:428] **Publishing findings:** The Commissioner and Attorney General are empowered to "publish information concerning any violation" of the Corporate Securities Law or any rule or order thereunder. [Corps.C. § 25531(a); Gov.C. § 12659(a)]

(3) [5:429] **Order by Commissioner to halt unlawful acts:** The Commissioner may issue a "desist and refrain" order upon concluding (a) securities subject to qualification are being offered or sold without a permit, (b) federally-preempted securities are being offered or sold in violation of any state notice requirements (*see ¶ 5:18.7 ff.*), (c) an offer or sale is being made by misrepresentation (*¶ 5:390 ff.*), or (d) a violation of the Corporate Securities Law or a Rule or order of the Commissioner is occurring or about to occur. A copy of the order is sent to the Attorney General and the district attorney of the county in which the issuer resides or maintains a principal place of business (*see ¶ 5:431*). [Corps.C. §§ 25532(a), (c), (d), 25533.5; see *Consolidated Mgmt. Group, LLC v. Department of Corporations*(2008) 162 CA4th 598, 608, 75 CR3d 795, 804—Commissioner has authority to interpret federal exemptions/preemption when enforcing California securities law; *Department of Corporations v. Sup.Ct. (Adams)* (2007) 153 CA4th 916, 922, 63 CR3d 624, 626—Department of Corporations (now Department of Financial Protection and Innovation) not liable to investors for losses suffered after Commissioner rescinded "desist and refrain" order entered against securities sellers]

Moreover, the Commissioner may issue a "stop order," suspending or revoking qualification, if they conclude that some condition of the permit is being violated, or that the proposed plan of business is "not fair, just, or equitable," or that the issuance "will tend to work a fraud upon the purchaser thereof." [Corps.C. § 25140(a)]

(4) [5:430] **Civil proceeding seeking injunction and other remedies:** Either the Commissioner or the Attorney General can bring a superior court action to enjoin actual or threatened violations of the Corporate Securities Law or any rule or order issued thereunder. [Corps.C. § 25530(a); Gov.C. § 12658(a); see *People v. Simon* (1995) 9 C4th 493, 515-516, 37 CR2d 278, 292—injunction (and ancillary relief, ¶ 5:430b) available without showing D acted with knowledge of violation (dictum)]

In addition to the authority to issue an injunction or restraining order, the court may impose a receivership or conservatorship of the defendant's assets. [Corps.C. § 25530(a); Gov.C. § 13975.1]

(a) [5:430a] **Injunction barring individual from serving as officer or director:** A person who violated Corps.C. § 25401 (misrepresentation in sale or offer of securities, ¶ *5:390 ff.*), and whose conduct demonstrates "unfitness to serve" as an officer or director, may be enjoined from acting as an officer or director of a corporation that had a securities transaction that was qualified under Corps.C. § 25110 (¶ *5:195a*) or that was exempt from qualification. [Corps.C. § 25530.1]

(b) [5:430b] **Ancillary monetary remedies:** The injunction action may include a claim for ancillary monetary relief, such as restitution, disgorgement or damages on behalf of all persons injured by defendant's unlawful conduct. A restitution order may be cast as a *money judgment* enforceable by the victim as any other civil judgment. [Corps.C. § 25530(b), (c); Gov.C. § 12658(b), (c); see *Capital Research & Mgmt. Co. v. Brown* (2007) 147 CA4th 58, 63-64, 53 CR3d 770, 773-774]

1) [5:430c] **Broader liability than in private action:** Restitution or damages liability in a Corps.C. § 25530(b) civil action extends to *anyone injured by the securities law violation* and hence may be broader than in a private action.

For example, where liability is based on misrepresentation under Corps.C. § 25401 (¶ *5:390 ff.*), purchasers may bring a *private* action to obtain rescission or damages only from the *direct seller* of the securities (privity requirement, ¶ *5:392, 5:399.1*). However, in a § 25530(b) civil action, the Commissioner may obtain restitution on behalf of purchasers from any person who *committed or materially participated in* the misrepresentation. [*People ex rel. DuFauchard v. O'Neal* (2009) 179 CA4th 1494, 1503-1504, 102 CR3d 573, 579-580]

(c) [5:430.1] **Civil penalties:** The Commissioner or Attorney General may also seek civil penalties not to exceed $25,000 for each violation of the Corporate Securities Law or any rule or order promulgated thereunder. [Corps.C. § 25535(a); Gov.C. § 12660(a)]

(d) [5:430.2] **Four-year limitations period:** A four-year statute of limitations applies to actions brought by the Commissioner or Attorney General to enforce the Corporate Securities Law. [Corps.C. § 25535(c), Gov.C. § 12660(c)—action to recover civil penalty must be brought within 4 years after act constituting the violation; see *People v. Martinson* (1986) 188 CA3d 894, 899-900, 233 CR 617, 620—CCP § 343 (action must be brought within 4 years after "accrual") applies to other civil proceedings brought by Commissioner]

(*Compare: Private actions* brought to rescind or recover damages for unqualified securities sales are subject to a *two-year* limitations period; *see* ¶ *5:416*.)

h. [5:431] **Criminal sanctions:** A criminal violation of the Corporate Securities Law, or any rule or order thereunder, may be prosecuted by the California Attorney General or the district attorney of the county in which the violation occurs. [Corps.C. § 25533]

"Willful" violations are punishable by a fine of up to $10,000,000 ($25,000,000 for certain violations by a 1934 Act reporting company) and imprisonment in state prison or in a county jail for one to five years, depending on the violation. [Corps.C. § 25540(a)-(c)]

"Willfully" fraudulent practices in connection with the offer or sale of any security are likewise punishable by fine and imprisonment. [Corps.C. § 25541]

(1) [5:431a] **Three-year limitations period:** Generally, criminal prosecution must commence within three years after *discovery* of the offense. [Pen.C. §§ 801, 803(c); see *People v. Fine* (1997) 52 CA4th 1258, 1263-1266, 61 CR2d 254, 257-259]

(2) [5:431b] **Knowledge requirement for rule or order violation:** No person may be imprisoned for violation of any rule or order adopted under the Corporate Securities Law if the person proves they had *no knowledge* of the rule or order. However, the "knowledge" requirement does *not* apply to violation of a rule or order adopted pursuant to Corps.C. § 25400 (market manipulation/deception, ¶ *5:419.5*), § 25401 (misrepresentation in sale of securities, ¶ 5:390 ff.), or § 25402 (insider trading, ¶ 6:382 ff.). [Corps.C. § 25540(a), (b)]

(3) [5:431c] **Jury must decide if a "security" exists:** In criminal proceedings brought under Corps.C. § 25510 (failure to qualify), § 25401 (misrepresentation in sale of securities, ¶ *5:390 ff.*) or § 25541 ("willfully" fraudulent practices, ¶ *5:431*), the jury must decide whether a particular investment is a "security." A court may not determine the question as a matter of law, no matter how clear and convincing the evidence. Reason: This preserves the accused's constitutional right

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

to a jury trial on each element of the offense. (But this rationale does not apply to *civil* actions—e.g., to rescind unqualified securities transactions, or for securities fraud damages (*¶ 5:359 ff.*).) [*People v. Figueroa* (1986) 41 C3d 714, 734, 224 CR 719, 733; *People v. Black* (2017) 8 CA5th 889, 899, 214 CR3d 402, 410-411; *People v. Frederick* (2006) 142 CA4th 400, 413, 48 CR3d 585, 596-597]

(4) Section 25401 misrepresentation

(a) [5:431.1] **Scienter requirement:** As a general intent crime, Corps.C. § 25401 requires scienter—i.e., "guilty knowledge of the facts which make the act a crime." [*People v. Koenig* (2020) 58 CA5th 771, 795-796, 272 CR3d 732, 751-752 (internal quotes and citations omitted)]

For purposes of § 25401, a defendant must have acted either (i) with *actual knowledge of the falsity or misleading nature* of a statement or of the *materiality of an omission*, or (ii) with *criminal negligence in failing to investigate and discover same*. The prosecution has the burden of proving such knowledge as an element of the § 25401 violation. [*People v. Simon* (1995) 9 C4th 493, 517, 37 CR2d 278, 293; *People v. Salas* (2006) 37 C4th 967, 978, 38 CR3d 624, 632; *People v. Butler* (2012) 212 CA4th 404, 424-425, 151 CR3d 352, 370]

(b) [5:431.1a] **Act must be willful:** Although criminal negligence may satisfy the knowledge element of Corps.C. § 25401 (¶ 5:431.1), the underlying act ("offering or selling a security by means of a communication that includes an untrue material fact or omits a material fact"; *see ¶ 5:390 ff.*) must be willful. Criminal negligence does *not* satisfy § 25401's actus reus element. [*People v. Koenig* (2020) 58 CA5th 771, 795-796, 272 CR3d 732, 751-752]

(c) [5:431.1b] **Conspiracy liability:** A defendant may be properly charged with conspiracy to violate Corps.C. § 25401 because it is a "prohibited act crime," not a criminal negligence or "unintended result crime." [*People v. Koenig* (2020) 58 CA5th 771, 798-799, 272 CR3d 732, 753-754]

(d) [5:431.1c] **Aider and abettor liability:** A defendant may be criminally liable for aiding and abetting a violation of Corps.C. § 25401. [*People v. Koenig* (2020) 58 CA5th 771, 800, 272 CR3d 732, 755]

(e) [5:431.1d] **Mistake of law defense:** Mistake of law is a defense to Corps.C. § 25401 if the mistake either (i) negates the specific intent of the crime, or (ii) negates the requisite mental state (actual knowledge or criminal negligence). [*People v. Koenig* (2020) 58 CA5th 771, 806-807, 272 CR3d 732, 760]

(5) Offer or sale of unqualified security in violation of § 25110

(a) [5:431.2] **Good faith belief in exemption as defense:** An offeror or seller of an unqualified security who *reasonably and in good faith* believed that the security was *exempt* from qualification is *not guilty* of violating Corps.C. § 25110. However, the prosecution need not prove, as an element of the offense, that defendant knew the security was not exempt. Rather, defendant's good faith belief is an *affirmative defense* on which defendant bears the initial burden of proof. Where defendant presents sufficient evidence to raise a reasonable doubt regarding defendant's knowledge, the judge must instruct the jury that defendant can be convicted only if they *knew* that the security was not exempt *or they were criminally negligent in failing to know* that the security was not exempt. [*People v. Salas* (2006) 37 C4th 967, 981-982, 38 CR3d 624, 634-635; see *People v. Cole* (2007) 156 CA4th 452, 475, 67 CR3d 526, 544]

(b) [5:431.3] **Good faith belief that sale did not involve a security:** Similarly, proof that defendant knew they were selling a *security* is *not* an element of a Corps.C. § 25110 (or any other) securities offense. Here again, a reasonable, good faith belief that, e.g., a promissory note was not a security, is at most an affirmative defense to § 25110. [*People v. Butler* (2012) 212 CA4th 404, 418, 151 CR3d 352, 365; *see ¶ 5:431c*]

[5:431.4 - 5:431.10] ***Reserved.***

i. [5:431.11] **Good faith compliance with Commissioner's interpretive opinion as defense to liability:** A person may request the Commissioner to issue an interpretive opinion setting forth a written answer to *an unsettled question of law* arising under the Corporate Securities Law. A person named in the opinion is shielded from liability under the Corporate Securities Law for acts or omissions done in good faith reliance on the opinion. [Corps.C. § 25700; Commr.Rel.No. 61-C (revised 2014); see Corps.C. § 25618; Commr. Rule 250.12]

(1) [5:431.12] **Form of request:** A request for an interpretive opinion should:

• Be in writing and addressed to the Commissioner in care of the Legal Division, 1515 K St., Ste. 200, Sacramento, CA 95814;

• Specifically state that the letter is a request for an interpretive opinion (or, if only informal guidance is desired, the request should so indicate);

• Name the principal parties to the transaction;

• Specify each legal question presented, and describe all relevant facts and circumstances (enclosing, when appropriate, relevant documents, such as copies of agreements or offering materials);

• Include an *objective legal analysis* with a *reasoned conclusion* for each question presented (based on applicable law and regulations, previous opinions, state and federal court decisions, SEC no-action letters, etc.); and

• Make any desired request for confidentiality (see Commr. Rule 250.10). [Commr.Rel.No. 61-C (revised 2014)]

(2) [5:431.13] **Commissioner's discretion to issue opinion:** The Commissioner may decline to issue an interpretive opinion. In particular, the Commissioner will likely decline a request that:

• Fails to comply with any of the requirements for a request (¶ 5:431.12);

• May be answered by reviewing applicable law, Rules, previous opinions or other authority;

• Involves primarily a *factual* question;

• Raises a question involving a *past* transaction, a *violation of law*, *ongoing litigation* or an *enforcement matter;* or

• Involves an *advisory* or *hypothetical* opinion. [Commr.Rel.No. 61-C (revised 2014); see Commr. Rule 250.10]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 5-D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 5. Share Issuance:
Securities Law Considerations

D. Issuing Securities

- 1. [5:432] Effecting Transfer of Consideration
  - a. [5:433] Securities issued for cash
  - b. [5:435] Securities issued for noncash consideration
    - (1) [5:436] Caution—bulk sales law
    - (2) [5:438] Caution—need for third-party consent to transfer
- 2. [5:440] Issuance of Securities
  - a. Debt securities
    - (1) [5:441] Form
    - (2) [5:442] Tax criteria
    - (3) [5:443] Securities law requirements
  - b. [5:444] Share certificates
    - (1) [5:445] Effect of certificate
      - (a) [5:446] Remedies to compel delivery of certificate
    - (2) [5:447] Contents of certificate
      - (a) [5:448] *Name* of the shareholder. [Corps.C.…
      - (b) [5:449] *Number* of shares, and designation…
      - (c) [5:450] Where shares are issued in…
      - (d) [5:451] Unless included in the statement…
    - (3) [5:461] Form of certificate
      - (a) [5:462] Face vs. reverse of certificate
        - 1) [5:462.1] Legends required on face
      - (b) [5:463] "Conspicuous" print
      - (c) [5:464] Other print requirements
      - (d) [5:464.1] Effect of failure to comply
    - (4) [5:465] Signatures on share certificate
    - (5) [5:467] Delivery of certificate
      - (a) [5:468] Accompanying transfer restrictions
    - (6) [5:469] Entry in share register
    - (7) [5:471] Use of transfer agent and registrar
  - c. [5:472] Uncertificated shares
    - (1) Notice to transferees
      - (a) [5:473] Constructive notice of share attributes
      - (b) [5:474] Compare—*actual* notice required for transfer restrictions

(2) [5:475] Compare—blockchain system

1. [5:432] **Effecting Transfer of Consideration:** Shares may be issued only after receipt by the corporation of whatever lawful consideration has been agreed upon for their issuance. (As to permissible forms of consideration, *see ¶ 3:307 ff.*)

a. [5:433] **Securities issued for cash:** If securities are being issued for cash, the cash must be received by the corporation before or at the time of issuance. Counsel should confirm such receipt by obtaining a copy of the corporation's bank deposit, or other record (e.g., an officer's certificate) reflecting receipt of the cash consideration.

➪ [5:434] ***PRACTICE POINTER:*** This is particularly important where you are relying on the § 25102(h) exemption (¶ 5:236). That exemption requires counsel to file with the Financial Protection and Innovation Commissioner an opinion that the share issuance meets each of the conditions for the exemption, including the consideration received by the corporation. Before rendering such an opinion, you will need to confirm that the cash consideration has in fact been received.

To avoid any uncertainty, you may also wish to verify that the monies received have been properly credited on the corporation's books or obtain an officer's certificate to this effect. (Normally, they should be credited to “common stock” or similar account.) This will show that the cash was accepted by the corporation for its shares, rather than as a loan or as payment for some other asset or service.

b. [5:435] **Securities issued for noncash consideration:** If shares are being issued for assets other than cash, it is usually counsel's responsibility to make sure that there has been a legally effective transfer of such assets.

What constitutes a legally effective transfer, of course, depends on the type of assets involved. With real property and tangible personal property (vehicles, machinery, inventory, etc.), the transfer ordinarily requires preparation, execution and recordation of documents of title (grant deeds or quitclaim deeds for real property; assignments of leases; assignments and bills of sale of personal property, etc.).

(1) [5:436] **Caution—bulk sales law:** Where shares are being issued in exchange for the assets of a going business, the bulk sales law may apply (Comm'l C. § 6101 et seq.). Failure to comply exposes the transferee (buyer) to liability for damages in the amount of each creditor's claim (reduced by any nonrecoverable amounts). (*See ¶ 4:511 ff.*)

➪ [5:437] ***PRACTICE POINTER:*** However, as a practical matter, corporations taking over existing businesses usually *assume* the debts and liabilities of the business as part of the transaction. (The shares being issued by the corporation for the business assets reflects their value *after* reduction for the debts and liabilities assumed by the corporation.)

In such cases, there is no advantage to complying with the bulk sales law. Hence, compliance is important only in cases where the corporation is acquiring a going business' assets but *not* assuming its liabilities.

(2) [5:438] **Caution—need for third-party consent to transfer:** Often, property is subject to liens or security interests which restrict the transferor's right to sell or transfer without the lienholder's consent. For example, trust deeds on real property may contain “due on sale” clauses, accelerating the debt upon transfer of title, absent the lender's consent. And, leases of real or personal property often contain provisions against assignment or sublease without the lessor's prior consent.

It is the responsibility of counsel for the issuer to determine whether the transfer of title will violate any such restriction on transfer, and the effect of any such violation.

➪ [5:439] ***PRACTICE POINTER:*** It may be possible to obtain the consent of the secured party simply by showing that the former owners retain control of the corporation (where such is the case).

However, it is best *not* to leave such matters to the time of transfer. It is better practice to negotiate in advance (i.e., at the time the loan or lease is made) for the secured party's consent to this type of transfer. For example, a provision stating “a sale or assignment to a corporation in which borrower is a (majority) shareholder shall not require prior consent of lender or cause an acceleration of the debt secured hereby.”

2. [5:440] **Issuance of Securities:** The process of formally issuing a share certificate or other security is often handled by a corporate officer (or stock transfer agent, in a larger issuance). However, it is usually counsel's responsibility to make sure that such issuance complies with applicable requirements of the Corporations Code and federal and state securities laws.

a. Debt securities

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [5:441] **Form:** Corporate bonds, debentures, notes or other debt securities should be evidenced by a written instrument, executed by a corporate officer. The form of the instrument should be approved in advance by resolution of the board of directors. Likewise, the authority of the corporate officer should be established by prior resolution of the board of directors.

The securities themselves may be issued either in negotiable ("pay to the order of ___________"), or nonnegotiable ("pay to ___________") form.

(2) [5:442] **Tax criteria:** To qualify as bona fide debt for tax purposes, and to avoid potential reclassification as stock or "equity," the instruments should meet the criteria of IRC § 385 (*see ¶ 3:41 ff.*).

(3) [5:443] **Securities law requirements:** Usually, debt is structured so as to fit within one or more exemptions from registration and qualification under state and federal securities law. If no such exemption applies, however, the corporation will have to obtain a permit, and the terms of the instrument will have to meet the "fairness" standards established by the Financial Protection and Innovation Commissioner (*¶ 5:318 ff.*).

(For discussion of usury law and Commercial Code limitations, *see ¶ 3:72.1 ff.*)

b. [5:444] **Share certificates:** Unless the corporation has adopted an electronic book-entry system (¶ 5:472), every shareholder is entitled to a certificate from the corporation, signed by certain officers, certifying the number of shares and the class or series of shares owned by the shareholder. [Corps.C. § 416(a)]

(1) [5:445] **Effect of certificate:** The share certificate is merely evidence of share ownership. Once a corporation agrees to sell its shares, the purchaser becomes the equitable owner thereof. The purchaser of such shares thus acquires the status of "shareholder," even without the execution and delivery of a share certificate. [See *Mitchell v. Beckman* (1883) 64 C 117, 121, 28 P 110, 111-112]

(a) [5:446] **Remedies to compel delivery of certificate:** The purchaser may sue for an *injunction* to compel the corporation and its officers to issue a certificate for the shares owned; or, alternatively, the purchaser may sue for damages. [See Corps.C. § 2202]

In addition, whichever officer is responsible for share issuance is subject to a *statutory penalty* ($100, plus $10 per day up to a maximum of $500) if they "unreasonably" neglect or refuse to issue a certificate, after written request from the purchaser. And, all other officers or directors who "unreasonably cause" such neglect or refusal are subject to a similar penalty. [Corps.C. § 2201]

Quite apart from statute, a purchaser could sue the corporation for specific performance of a subscription agreement (damages are not an adequate remedy if other shares are unavailable).

(2) [5:447] **Contents of certificate:** The certificate must contain the following information required by statute:

(a) [5:448] *Name* of the shareholder. [Corps.C. § 416(a)]

(b) [5:449] *Number* of shares, and designation of *class* or *series* of shares (e.g., "1,000 shares of Class B Preferred"). [Corps.C. § 416(a)]

(c) [5:450] Where shares are issued in classes or series, one of the following: (i) a *statement* of the rights, preferences, privileges and restrictions of each class or series; *or* (ii) a *summary* thereof, with reference to the appropriate provisions of the Articles (or board certificate of determination) establishing same; *or* (iii) a statement designating an office of the corporation where shareholders may obtain, without charge, a copy of such statement. [Corps.C. § 417]

(d) [5:451] Unless included in the statement or summary referred to above (¶ 5:450), any of the following, if applicable:

• [5:452] The shares are *assessable*; or, the shares are *not fully paid*, and the amounts paid and remaining due. [Corps.C. §§ 418(a)(2), 409(d); see also Corps.C. § 2800(b)(2) (SPCs)]

• [5:453] The shares are subject to *voting restrictions* (either a voting trust agreement, irrevocable proxy, or other restriction on voting rights "contractually imposed by the corporation"). [Corps.C. §§ 418(a)(3), 706(a), 705(e); see also Corps.C. § 2800(b)(3) (SPCs)]

• [5:454] The shares are subject to *transfer restrictions* (either pursuant to buy-sell agreement, *¶ 3:187 ff.*; or under a forfeiture condition relating to continuing performance of services, see IRC § 83, *¶ 2:174*; or as a condition of a permit granted by the Financial Protection and Innovation Commissioner, *see ¶ 5:355*). [Corps.C. § 418(a)(1); see also Corps.C. § 2800(b)(1) (SPCs)]

• [5:455] The shares are *redeemable* (either by the corporation or by preferred shareholders under certain circumstances; see Corps.C. § 402, *¶ 7:124*). [Corps.C. § 418(a)(4); see also Corps.C. § 2800(b)(4) (SPCs)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• [5:456] The shares are *convertible* into some other corporate security, and the period for such conversion. [Corps.C. § 418(a)(5); see also Corps.C. § 2800(b)(5) (SPCs)]

• [5:457] If issued by a *statutory close corporation*, the certificate must contain a "conspicuous" legend on the face thereof: "This corporation is a close corporation. The number of holders of record of its shares of all classes cannot exceed _ [a number not in excess of 35]. Any attempted voluntary inter vivos transfer which would violate this requirement is void. Refer to the articles, bylaws and any agreements on file with the secretary of the corporation for further restrictions." [Corps.C. § 418(c); *and see ¶ 3:241*]

• [5:457.1] If issued by a *social purpose corporation*, the certificate must contain a "conspicuous" legend on the face thereof: "This entity is a social purpose corporation organized under Division 1.5 of the California Corporations Code. The articles of this corporation state one or more purposes required by law. Refer to the articles on file with the Secretary of State, and the bylaws and any agreements on file with the secretary of the corporation, for further information." [Corps.C. § 2800(a); *and see ¶ 9:61*]

• [5:457.2] If issued by a *benefit corporation*, the certificate must contain a "conspicuous" legend on the face thereof: "This entity is a benefit corporation organized under Part 13 (commencing with Section 14600) of Division 3 of Title 1 of the California Corporations Code." [Corps.C. § 14631; *and see ¶ 9:540*]

• [5:458] If the certificate is for "*promotional shares*," the resale restrictions required by the Financial Protection and Innovation Commissioner. [Commr. Rule 260.141.1; *¶ 5:332*]

[5:459] *Reserved.*

• [5:460] If issued under a federal exemption from registration (e.g., SEC Rule 147 or 147A, ¶ 5:101), or as "restricted securities" under Regulation D (¶ 5:184), such legend as may be required or desirable under federal securities law.

(3) [5:461] **Form of certificate:** The form of the share certificate should be approved in advance by resolution of the board of directors; and if a permit is required, by the Financial Protection and Innovation Commissioner.

(a) [5:462] **Face vs. reverse of certificate:** Except as noted below (¶ 5:462.1), the information required by statute (¶ 5:447 ff.) may appear either on the face of the certificate *or* on the reverse so long as a reference thereto appears on the face. [Corps.C. § 174]

1) [5:462.1] **Legends required on face:** The statutory close corporation legend (¶ 5:457), social purpose corporation legend (¶ 5:457.1) and benefit corporation legend (¶ 5:457.2) must appear "on the face" of the certificate. [Corps.C. §§ 418(c), 2800(a) (SPCs), 14631 (benefit corporations)]

(b) [5:463] **"Conspicuous" print:** Certain of the statutorily required information on the certificate must be "conspicuous," i.e., "so written, displayed, or presented that, based on the totality of the circumstances, a reasonable person against whom it is to operate ought to have noticed it." [Comm'l C. § 1201(b)(10) (amended Stats. 2023, Ch. 210; eff. 1/1/24)]

• This applies to the legend required of a statutory close corporation (¶ 5:457), social purpose corporation (¶ 5:457.1) or benefit corporation (¶ 5:457.2). [Corps.C. §§ 418(c), 2800(a) (SPCs), 14631 (benefit corporations)]

• It also applies to any statement that the shares are subject to transfer restrictions (*¶ 5:454*), or are assessable or not fully paid (*¶ 5:452*). [Corps.C. § 418(a), last sent.]

(c) [5:464] **Other print requirements:** The legend required on issuance of "promotional shares" must be in minimum 10-point type capital letters. [Commr. Rule 260.141.1]

(d) [5:464.1] **Effect of failure to comply:** Failure to comply with the above requirements (¶ 5:447 ff.) renders transfer restrictions, redemption rights, and voting restrictions or irrevocable proxies *unenforceable* against a transferee who has no actual knowledge thereof. [Corps.C. § 418(b); see also Corps.C. § 2800(c) (SPCs)]

(4) [5:465] **Signatures on share certificate:** Share certificates must be signed in the name of the corporation by two corporate officers: One of them must be chairperson or vice chairperson of the board, or the president or vice-president; the other must be either the chief financial officer or the secretary or assistant secretary, or an assistant treasurer. [Corps.C. § 416(a)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

The signatures may be originals or facsimiles. A facsimile is valid even if the signer was no longer an officer of the corporation when the facsimile of their signature was affixed to the certificate. [Corps.C. § 416(a)]

[5:466] ***Reserved.***

(5) [5:467] **Delivery of certificate:** Physical delivery of the certificate to the issuee is usually handled by a corporate officer (or stock transfer agent, for larger issuances).

(a) [5:468] **Accompanying transfer restrictions:** The issuer of a security upon which resale or transfer restrictions have been imposed should also deliver to the issuee a copy of the applicable restrictions (whether or not reference thereto appears on the certificate).

(6) [5:469] **Entry in share register:** Every corporation must keep at its principal office (or at the office of its transfer agent or registrar, if it has designated such) a register showing each shareholder's name, address, and number and class of shares. (The register may be in writing or in another form capable of being converted into clearly legible tangible form, or in a combination of the two forms.) [Corps.C. § 1500; *see* ¶ *4:366*]

➪ [5:470] ***PRACTICE POINTER:*** In the case of corporations with relatively few shareholders, some lawyers use the certificate stubs as the share register. (Most "corporate kits" supplied to new corporations contain share certificates with detachable stubs.) However, it is good practice also to maintain a separate share register or ledger.

In all cases, the stubs and the separate share ledger should be filled out at the time the certificates are detached and issued. Make sure each stub and each share register entry contains all of the information required by § 1500: i.e., the names *and addresses* of each issuee, and the number and *class* of shares issued.

It is good practice to *obtain a written receipt* from the issuee, whether by having them sign the stub and share ledger (where practicable), by inserting a separately signed receipt in the book, or by sending all shares by certified mail and attaching the receipt to the records.

It is also good practice to place a notation on the stub itself (or on the reverse side) regarding any *separate documentation* furnished to the issuee along with the certificate: e.g., copies of statement of rights, preferences and privileges not appearing on face of certificate; or copies of transfer restrictions not appearing on face of certificate. Again, wherever possible, obtain the issuee's acknowledgment of receipt thereof, by having them sign your notation on the stub, or insert a separate receipt in the book.

(7) [5:471] **Use of transfer agent and registrar:** Corporations having only a limited number of shareholders do not need transfer agents or registrars. Such corporations customarily handle "in house" the mechanical aspects of issuing and transferring their securities, either by having the corporate secretary or its lawyer perform such functions.

But publicly-held corporations use professional transfer agents (usually banks or trust companies). Their services typically include not only transfers of securities, but preparation and certification of lists of security holders, disbursement of dividends, and mailing of notices of shareholder meetings, annual reports and other materials.

The primary function of a corporate registrar is to make sure that certificates are not issued for more shares (or other securities) than are authorized by the corporation's articles or by board action.

c. [5:472] **Uncertificated shares:** As an alternative to share certificates, a corporation may adopt a system of share issuance, registration and transfer by *electronic* or other means not involving issuance of certificates. Any such system must be approved by the SEC, or otherwise be authorized by federal law or in accordance with Division 8 of the California Commercial Code (Comm'l C. § 8101 et seq.); and must comply with any Rules adopted by the Financial Protection and Innovation Commissioner. [Corps.C. § 416(b)]

(1) Notice to transferees

(a) [5:473] **Constructive notice of share attributes:** It is incumbent upon the purchaser to ascertain the share attributes set forth in the corporation's articles or bylaws, or in the resolutions authorizing or issuing the shares. By law, the terms of an uncertificated security include those stated in any instrument or document pursuant to which the security is issued. [Comm'l C. § 8202(a)]

(b) [5:474] **Compare—*actual notice required for transfer restrictions:*** However, a transfer restriction is ineffective against a person having neither knowledge nor *notice* of the restriction. [Comm'l C. § 8204]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Thus, a corporation using a system of uncertificated shares must adopt a method to inform prospective purchasers of transfer restrictions. The corporation may do this by furnishing "initial transaction statements" or periodic "written statements" that set forth the restrictions (and that may also describe the share attributes). [See Corps.C. §§ 171.1, 174, 417, 418, 1302; see also Corps.C. § 2800 (SPCs)]

(2) [5:475] **Compare—blockchain system:** If permitted by the articles, electronic transfers of shares may be effected by blockchain technology. *See* ¶ *4:136.2, 6:591.2*.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 5:A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 5. Share Issuance:
Securities Law Considerations

Forms

[Form 5:A] Investment Representations Letter

Dear ___________:

This letter is being delivered by the undersigned in connection with the sale and issuance of _____ shares of _____ *(Company)*, *(for* $________*)*. The undersigned hereby represents that:

1. I am purchasing the shares in my own name and for my own account *(or for a trust account if I am a trustee)*, for investment and not with an intent to sell, or for sale in connection with any distribution of such stock; and no other person has any interest in or right with respect to the shares; nor have I agreed to give any person any such interest or right in the future.

2. I recognize that the shares have not been registered under the Federal Securities Act of 1933, as amended, or qualified under the California Corporate Securities Law of 1968, as amended, and that any disposition of the shares is subject to restrictions imposed by federal and state law. I also recognize that I cannot dispose of the shares absent registration and qualification, or an available exemption from registration and qualification. I understand that the California Commissioner of the Department of Financial Protection and Innovation has made no finding or determination relating to the fairness for investment of the shares offered by the Company and that the Commissioner has not and will not recommend or endorse the shares.

3. I have not seen or received any advertisement or general solicitation with respect to the sale of the shares.

4. I believe, by reason of my business or financial experience, that I am capable of evaluating the merits and risks of this investment and of protecting my own interests in connection with this investment.

   [OR]

   I have a pre-existing personal or business relationship with the Company or one or more of its officers, directors or controlling persons and am aware of its (their) character, business acumen, and general business and financial circumstances.

5. I acknowledge that during the course of this transaction and before purchasing the shares I have been provided with financial and other written information about the Company. I have been given the opportunity by the Company to obtain any information and ask questions concerning the Company, the shares, and my investment that I felt necessary; and to the extent I availed myself of that opportunity, I have received satisfactory information and answers.

6. In reaching the decision to invest in the shares, I have carefully evaluated my financial resources and investment position and the risks associated with this investment, and I acknowledge that I am able to bear the economic risks of this investment.

DATED: _____

____
(Name)

____
(Signature)

____
(Address)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 5:B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 5. Share Issuance:
Securities Law Considerations

Forms

[Form 5:B] Subscription Agreement

A California Corporation

(*)SUBSCRIPTION AGREEMENT

[(*)Derived from form furnished by Douglas L. Hammer of the law firm of Shartsis Friese LLP, San Francisco, California.]

1. SUBSCRIPTION: The undersigned (the "Subscriber") hereby irrevocably subscribes $________ for ___ shares (the "Shares") of the Common Stock of _____, a California corporation (the "Company"), which subscription, when and if accepted by the Company, will constitute the payment by the Subscriber of the purchase price for the Shares, as described in a Confidential Offering Circular dated ___________ (the "Offering Circular"), relating to the Company and its proposed business.

2. REPRESENTATIONS, WARRANTIES AND AGREEMENTS BY SUBSCRIBER: The Subscriber hereby represents, warrants and agrees as follows:

(a) The Shares are being purchased by the Subscriber and not by any other person, with the Subscriber's own funds and not with the funds of any other person, and for the account of the Subscriber, not as a nominee or agent and not for the account of any other person. On acceptance of this Subscription Agreement by the Company, no other person will have any interest, beneficial or otherwise, in the Shares. The Subscriber is not obligated to transfer Shares to any other person nor does the Subscriber have any agreement or understanding to do so. The Subscriber is purchasing the Shares for investment for an indefinite period and not with a view to the sale or distribution of any part or all thereof by public or private sale or other disposition. The Subscriber has no intention of selling, granting any participation in or otherwise distributing or disposing of any Shares. The Subscriber does not intend to subdivide the Subscriber's purchase of Shares with any person.

(b) The Subscriber has been advised that the Shares have not been registered under the Securities Act of 1933, as amended (the "Act"), or qualified under the California Corporate Securities Law of 1968, as amended (the "Law"), on the ground, among others, that no distribution or public offering of the Shares is to be effected [*Insert if relying on Sec. 25102(n): (other than such public solicitation as may be permitted by section 25102(n) of the Law)*] and the Shares will be issued by the Company in connection with a transaction [*Insert if relying on Rule 504: that is exempt under section 3(b) of the Act and*] that does not involve any public offering within the meaning of section 4(a)(2) of the Act or section 25102(f) of the Law [*Insert if relying on Sec. 25102(n): (other than such public solicitation as may be permitted by section 25102(n) of the Law)*], under the respective rules and regulations of the Securities and Exchange Commission and the California Commissioner of the Department of Financial Protection and Innovation thereunder. The Subscriber understands that the Company is relying in part on the Subscriber's representations as set forth herein for purposes of claiming such exemptions and that the basis for such exemptions may not be present if, notwithstanding the Subscriber's representations, the Subscriber has in mind merely acquiring Shares for resale on the occurrence or nonoccurrence of some predetermined event. The Subscriber has no such intention.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [*Insert if relying on § 4(a)(2) of the Act, § 25102(f) of the Law or Rule 506 under the Act.*] The Subscriber, either alone or with the Subscriber's professional advisers who are unaffiliated with, have no equity interest in and are not compensated by the Company or any affiliate or selling agent of the Company, directly or indirectly, has such knowledge and experience in financial and business matters that the Subscriber is capable of evaluating the merits and risks of an investment in Shares and has the capacity to protect the Subscriber's own interests in connection with the Subscriber's proposed investment in Shares.

[*Insert if relying on § 25102(f) of the Law but not relying on § 4(a)(2) of the Act or Rule 506 thereunder.*] Either:

(i) The Subscriber has a pre-existing personal or business relationship with one or more of the founding shareholders and directors of the Company who control the Company, consisting of personal or business contacts of a nature and duration sufficient to enable the Subscriber, as a reasonably prudent investor, to be aware of the character, business acumen and general business and financial circumstances of the persons with whom such relationship exists; or

(ii) By reason of the Subscriber's business and financial experience or the business or financial experience of the Subscriber's professional advisers who are unaffiliated with and who are not compensated by the Company or any affiliate or selling agent of the Company, directly or indirectly, the Subscriber has the capacity to protect the Subscriber's own interests in connection with the Subscriber's purchase of Shares; or

(iii) The Subscriber is an excluded purchaser as provided by section 25102(f) of the Law and section 260.102.13 of the California Administrative Code promulgated under the Law and has so indicated such status by marking one of the categories of "accredited investor" on the Subscriber's Offering Questionnaire attached hereto as Appendix I.

(d) The Subscriber either has previously furnished to the Company a completed and signed Offering Questionnaire or has completed and signed the Offering Questionnaire attached hereto as Appendix I. The information in the Subscriber's most recently completed and signed Offering Questionnaire previously delivered or being delivered to the Company, which is incorporated herein by reference, is true, correct and complete in all respects as of the date hereof.

(e) The Subscriber acknowledges receipt of the Offering Circular and each exhibit thereto as indicated therein and acknowledges that the Subscriber has been furnished with such financial and other information concerning the Company, the directors and officers of the Company and the business and proposed business of the Company as the Subscriber considers necessary in connection with the Subscriber's investment in Shares. The Subscriber has carefully reviewed the Offering Circular and each exhibit thereto, and is thoroughly familiar with the proposed business, operations, properties and financial condition of the Company and has discussed with officers of the Company any questions the Subscriber may have had with respect thereto. The Subscriber understands:

(i) The risks involved in this offering, including the speculative nature of the investment;

(ii) The financial hazards involved in this offering, including the risk of losing the Subscriber's entire investment;

(iii) The lack of liquidity and restrictions on transfers of Shares; and

(iv) The tax consequences of this investment.

The Subscriber has consulted with the Subscriber's own legal, accounting, tax, investment and other advisers with respect to the tax treatment of an investment by the Subscriber in Shares and the merits and risks of an investment in Shares.

(f) [*Insert only if relying on § 4(a)(2) of the Act.*] Understanding that the investment in Shares is highly speculative, the Subscriber is able to bear the economic risk of such investment. The Subscriber has a net worth of at least $1,000,000 (exclusive of home, furnishings and automobiles) or, if such net worth is less than $1,000,000, the Subscriber had an individual income in excess

of $200,000 in each of the two most recent years or joint income with his or her spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

(g) If the Subscriber is an individual, the Subscriber is a citizen of the United States over twenty-one years of age; and if the Subscriber is an unincorporated association, all of its members are such citizens of such age. If the Subscriber is a corporation, partnership, limited liability company, trust or other entity, the Subscriber was not formed for the purpose of investing in Shares and has or will have other substantial business or investments.

(h) The Subscriber, if not an individual, is empowered and duly authorized to enter into this Subscription Agreement under any governing document, partnership agreement, limited liability company agreement, trust instrument, pension plan, charter, certificate of incorporation, bylaw provision or the like; this Subscription Agreement constitutes a valid and binding agreement of the Subscriber enforceable against the Subscriber in accordance with its terms; and the person signing this Subscription Agreement on behalf of the Subscriber is empowered and duly authorized to do so by the governing document or trust instrument, pension plan, charter, certificate of incorporation, bylaw provision, board of directors or stockholder resolution, or the like.

3. AGREEMENT TO REFRAIN FROM RESALES: Without in any way limiting the representations and warranties herein, the Subscriber further agrees that the Subscriber shall in no event pledge, hypothecate, sell, transfer, assign or otherwise dispose of any Shares, nor shall the Subscriber receive any consideration for Shares from any person, unless and until prior to any proposed pledge, hypothecation, sale, transfer, assignment or other disposition:

(a) A registration statement on Form S-1 under the Act (or any other form appropriate for the purpose under the Act or any form replacing any such form) with respect to the Shares proposed to be so disposed of shall be then effective and such disposition shall have been appropriately qualified in accordance with the Law and any other applicable securities law; or

(b)(i) The Subscriber shall have furnished the Company with a detailed explanation of the proposed disposition, (ii) the Subscriber shall have furnished the Company with an opinion of the Subscriber's counsel in form and substance satisfactory to the Company to the effect that such disposition will not require registration of such Shares under the Act or qualification of such Shares under the Law or any other securities law and (iii) counsel for the Company shall have concurred in such opinion and the Company shall have advised the Subscriber of such concurrence.

4. CERTIFICATES REPRESENTING SHARES TO BE LEGENDED: The Subscriber understands and agrees that any certificate representing Shares or relating to Shares may bear such legends as the Company may consider necessary or advisable to facilitate compliance with the Act, the Law and any other securities law, including without limitation legends stating that the Shares have not been registered under the Act or qualified under the Law and setting forth the limitations on dispositions imposed hereby.

5. SHARES WILL BE RESTRICTED SECURITIES: The Subscriber understands that the Shares will be “restricted securities” as that term is defined in Rule 144 under the Act and, accordingly, that the Shares must be held indefinitely unless they are subsequently registered under the Act and qualified under the Law and any other applicable securities law or exemptions from such registration and qualification are available. The Subscriber understands that the Company is under no obligation so to register Shares under the Act, to qualify Shares under any securities law, or to comply with Regulation A or any other exemption under the Act, the Law or any other law.

6. COMPANY MAY REFUSE TO TRANSFER: Notwithstanding the foregoing, if, in the opinion of counsel for the Company, the Subscriber has acted in a manner inconsistent with the representations and warranties in this Subscription Agreement, the Company may refuse to transfer the Subscriber's Shares until such time as counsel for the Company is of the opinion that such transfer will not require registration of Shares under the Act or qualification of Shares under the Law or any other securities law. The Subscriber understands and agrees that the Company may refuse to acknowledge or permit any disposition of Shares that is not in all respects in compliance with this Subscription Agreement and that the Company intends to make an appropriate notation in its records to that effect.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

7. INDEMNIFICATION: The Subscriber hereby agrees to indemnify and defend the Company and its directors and officers and hold them harmless from and against any and all liability, damage, cost or expense incurred on account of or arising out of:

(a) Any breach of or inaccuracy in the Subscriber's representations, warranties or agreements herein;

(b) Any disposition of any Shares contrary to any of the Subscriber's representations, warranties or agreements herein; and

(c) Any action, suit or proceeding based on (i) a claim that any of said representations, warranties or agreements were inaccurate or misleading or otherwise cause for obtaining damages or redress from the Company or any director or officer of the Company under the Act or (ii) any disposition of any Shares.

8. SUCCESSORS: The representations, warranties and agreements contained in this Subscription Agreement shall be binding on the Subscriber's successors, assigns, heirs and legal representatives and shall inure to the benefit of the respective successors and assigns of the Company and its directors and officers.

Number of Shares Subscribed: _____

Amount of Enclosed Check: $________

TYPE OF OWNERSHIP (Check One)

___ INDIVIDUAL OWNERSHIP
(one signature required)

___ COMMUNITY PROPERTY
(one signature required)

___ TENANTS-IN-COMMON
(Both parties must sign)

___ TRUST
(Please include name of trust, name of trustee and date trust was formed, and include copy of the Trust Agreement or other authorization)

___ PARTNERSHIP
(Please include a copy of the Statement of Partnership or Partnership Agreement authorizing signature)

___ CORPORATION
(Please include Articles of Incorporation, Certified Corporate Resolution authorizing signature and Incumbency Certificate of signing Officer)

___ LIMITED LIABILITY COMPANY
(Please include a copy of the Articles of Organization and any Operating Agreement)

Dated: ___________

Investor:

____
Print or type name

____
Signature

____
Name and title of person signing on behalf of investor, if applicable

____
Social Security or Tax ID Number
Address: _____

____
[Add Appropriate Acknowledgment]

Co-investor:

____
Print or type name

____
Signature

____
Relation, if any, to Investor

____
Social Security or Tax ID Number
Address: _____

____

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 5:C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 5. Share Issuance:
Securities Law Considerations

Forms

[Form 5:C] Offeree Questionnaire

OFFERING QUESTIONNAIRE

[Company name]

[Title of Securities]

(All Information Will Be Treated Confidentially)

INSTRUCTIONS

This Questionnaire is being distributed to a select group of investors, each of whom the officers of ________________, a ________________ corporation (the "Company"), believe may find investment in the Company suitable for such investor's long-range investment objectives. The primary purpose of this Questionnaire is to elicit information sufficient to permit the Company reasonably to conclude that you have sufficient investment sophistication and ability to take financial risk to meet the standards for availability of the private offering exemption from the registration requirements of the Securities Act of 1933, as amended (the "Act"), and the qualification requirements of any other applicable securities law.

If, in completing this Questionnaire, you are in doubt regarding the meaning or implication of any of the terminology or regarding the significance of any particular question, please contact ___________ at ___________, California ___________, telephone ( ) If the answer to any question is "None" or "Not Applicable," please so state.

YOUR ANSWERS WILL AT ALL TIMES BE KEPT STRICTLY CONFIDENTIAL. EACH PERSON SIGNING THIS QUESTIONNAIRE AGREES, HOWEVER, THAT THE COMPANY MAY PRESENT THIS QUESTIONNAIRE TO SUCH PARTIES AS IT DEEMS APPROPRIATE IF CALLED ON TO ESTABLISH THE AVAILABILITY OF AN EXEMPTION FROM REGISTRATION OF THE SHARES UNDER THE ACT OR REGISTRATION OR QUALIFICATION OF THE SHARES UNDER THE LAW OR ANY OTHER SECURITIES LAW.

Unless you have already furnished a completed and signed Offering Questionnaire to the Company, or have otherwise furnished to the Company all of the information elicited by this Questionnaire, and unless the information furnished is still true and complete, please complete, sign, date and return one copy of this Questionnaire, together with your completed, dated and signed Subscription Agreement and check, to the Company at the address in the second paragraph of this Questionnaire. If the Company

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

already has your current Offering Questionnaire, you need only send your completed, dated and signed Subscription Agreement and check. A return envelope is enclosed for your convenience. You should retain a copy of each document for your files.

Note for Certain Employee Benefit Plans: If you are a self-directed plan that believes it is an "accredited investor" because investment decisions are made solely by persons that are accredited investors (see Part E, category (3)), please furnish a separate Questionnaire with respect to you and each such person participating in making the investment decision.

Note for Trusts: If you are a trust that believes it is an "accredited investor" described in Part E, category (4), please furnish a separate Questionnaire with respect to you and each person participating in making the investment decision (except that persons participating in making the investment decision need not complete Parts C, E and F).

Note for Certain Entities: If you are an entity that believes it is an "accredited investor" by virtue of the accredited investor status of each equity owner thereof (see part E, category (13)), please furnish a separate Questionnaire with respect to you and each such equity owner.

A. Identifying Information

Full Name(s): ________________

Home Address: ________________

Home Phone: ________________

Business Address: ________________

Business Phone: ________________

Date of Birth: ________________

Marital Status: ________________

Number of Dependents: ________________

In what state do you maintain your principal residence? (If you have resided in this state less than one year, or plan to change your state of residence, please explain.)

Is there any reason you might be considered a resident of another state (e.g., live part of the year, have an office or business, registered to vote, pay taxes or hold a driver's license in another state)? If so, please explain:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

If you are a corporation, trust, partnership, limited liability company, association or other entity, please identify the jurisdiction under the laws of which you are organized and existing, and the jurisdiction where your principal place of business is located:

B. Employment and Background

If you are an individual, please furnish all of the following information regarding yourself. If spouses are investing jointly, please furnish all of the following information with respect to each spouse and identify the spouse to which the information pertains. If you are an entity or are investing jointly with a person other than your spouse, please furnish all of the following information in this Part B regarding each officer, partner, member, trustee or other person who will participate in the investment decision. If you are acting as a custodian of a minor whose funds will be invested, please furnish information in this Part B regarding yourself only.

Education:

College/University	Degree	Major	Year
....	....	....	....
....	....	....	....
....	....	....	....

Employment:

Name and Address of Current Employer ________________..

Nature of Employment ________________

If self-employed, nature of business ________...

Name and Address of Current Employer of Spouse/Co-investor

____

____

____

Nature of Employment ....

If self employed, nature of business ________...

Describe briefly all positions (including directorships) held during the past five years which were related to financial, business, accounting, economics, taxation or investment matters which you feel demonstrate your investment sophistication. Where appropriate, briefly describe the business of the company or other entity in which the position was held:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Other background in business (particularly in the *[industry in which Company will be involved]*), economics, finance, accounting, taxation, law, investing or related fields (include any relevant educational experience) that demonstrates investment sophistication:

C. Financial Information

General Instructions: If you are an entity (corporation, partnership, trust, etc.), complete the section below entitled "Entities." In addition, each partner of an investor that is a partnership, each member of an investor that is a limited liability company, each beneficiary of an investor that is a trust and each shareholder of an investor that is a closely held corporation should complete the section below entitled "Individuals." If you are acting as custodian for a minor, the minor's financial information (not the custodian's) should be given.

Entities:

Type of Entity: ....

Number of partners, members, shareholders or beneficiaries: ___________

Is the investor an "employee benefit plan" within the meaning of the Employment Retirement Income Security Act of 1974, as amended?

Yes _____ No _____

If the investor is a trust other than such an "employee benefit plan" is the trust "revocable" pursuant to its trust agreement?

Yes _____ No _____

What is the investor's approximate net worth? $________

Individuals (including certain partners, members, shareholders and beneficiaries). (See general instructions.)

Was your gross income from all sources (check appropriate blank(s)):

	For Calendar Year Prior to Last Year	**For Last Year**	**Reasonably Expected for This Year**
Alone greater than:			
$100,000	_____	_____	_____
$200,000	_____	_____	_____
$300,000	_____	_____	_____
Jointly with spouse greater than:			
$100,000	_____	_____	_____
$200,000	_____	_____	_____

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

$300,000	_____	_____	_____

Is your individual or joint net worth with your spouse (excluding personal residence, furnishings and automobiles), as of the date hereof, at least five times the amount of your proposed investment?

Yes _____ No _____

ten times the amount of your proposed investment? Yes ___ No ___

$1,000,000? Yes ___ No ___

D. Investment Background and Objectives

Approximate number of years you have been investing: ___________

Please indicate the frequency of your investments in:

Real estate other than your principal residence (directly or through partnerships or other entities managed by others):

( ) often ( ) occasionally ( ) seldom ( ) never

Tax shelter programs (e.g., real estate, leasing, oil and gas, cattle breeding):

( ) often ( ) occasionally ( ) seldom ( ) never

Marketable securities (stocks, bonds, debentures, notes):

( ) often ( ) occasionally ( ) seldom ( ) never

Approximate current portfolio value: $________

Privately held corporations and partnerships and start-up ventures (stocks, bonds, debentures, notes, partnership interests):

( ) often ( ) occasionally ( ) seldom ( ) never

Approximate current portfolio value: $________

Type of Investment (direct or through partnerships or other management entities)	Number of Investments	Dollar Amount	Date(s)
Venture capital funds	_____	___	___
Private equity funds	_____	___	___

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Real estate investment funds	_____	___	___
Stock of publicly held corporations	_____	___	___
Mutual funds	_____	___	___
Other	_____	___	___

Order of Objectives (number preferences from 1 to 3, from most preferred to least):

[ ] Income

[ ] Capital Appreciation

[ ] Liquidity

E. "Accredited Investor"

If you are an "accredited investor" as that term is defined in Regulation D under the Act and under the rules of the California Commissioner of the Department of Financial Protection and Innovation under section 25102(f) of the Law, please indicate by check mark(s) in the appropriate space(s) below the category or categories that accurately describe your situation.

For the purpose of calculating individual net worth, do not include the value of your primary residence as an asset. Likewise, debt secured by your primary residence, up to the estimated fair market value of the residence, should not be included as a liability. But if the amount of that debt, at the time you agree to purchase your investment in the Company, exceeds the amount of that debt 60 days before you agree to purchase your investment in the Company, then the amount of the excess should be included as a liability unless the excess is the result of the acquisition of your primary residence. (In other words, if the debt on your primary residence increases during the 60-day period before you make your investment in the Company, the amount of that increase should be considered a liability unless the increase was the result of acquiring your primary residence.) In addition, debt secured by your primary residence in excess of the estimated fair market value of the residence should be included as a liability in calculating your net worth.

___(1) A natural person (not an entity) whose individual net worth, or joint net worth with his or her spouse, at the time of his or her purchase exceeds $1,000,000 (excluding the value of his or her primary residence);

___(2) A natural person (not an entity) who had an individual income in excess of $200,000 in each of the preceding two years or joint income with his or her spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

___(3) An employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) thereof, which is either a bank, savings and loan association, insurance company or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

___(4) A trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities of the Company being offered, whose purchase is directed by a person who has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment in the Company;

___(5) A bank as defined in section 3(a)(2) of the Act, or a savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act, whether acting in its individual or fiduciary capacity;

___(6) A broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934;

___(7) An insurance company as defined in section 2(13) of the Act;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

___(8) An investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of the Investment Company Act of 1940;

___(9) A Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c), (d) of the Small Business Investment Act of 1958;

___(10) A private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

___(11) An organization described in section 501(c)(3) of the Internal Revenue Code, a corporation, a Massachusetts or similar business trust, or a partnership not formed for the specific purpose of acquiring the securities of the Company being offered, with total assets in excess of $5,000,000;

___(12) A director or executive officer of the Company; or

___(13) An entity in which all the equity owners are accredited investors.

For purposes of categories (1) and (2) above, you will be considered an accredited investor only if you also meet one of the following tests:

(a) You or your professional adviser can be reasonably assumed to have the capacity to protect your own interests in connection with the transaction by reason of your business or financial experience or the business or financial experience of your adviser (who is unaffiliated with or who is not compensated by the Company or any affiliate or selling agent of the Company, directly or indirectly);

(b) You can reasonably be assumed to be able to bear the economic risk of your investment in the Company; or

(c) Your investment in the Company does not exceed ten percent of your net worth.

If you have indicated category (3) above and if you are a self-directed employee benefit plan with investment decisions made solely by persons that are accredited investors, or if you have indicated category (13) above, please list below the names and categories of accreditation of the accredited investors making the investment decisions (category (3)) or who are the equity owners (category (13)) (attach additional pages if necessary):

Person Making Decision/Equity Owner	**Accredited Investor Category**
________________	_____
________________	_____
________________	_____

F. Purchaser Representative

You will be eligible to invest in the Company only if you, either alone or together with your "purchaser representative" (such as an investment adviser, attorney, accountant or other consultant), have such knowledge and experience in financial and business matters that you are capable of evaluating the merits and risks of an investment in the Company and have the capacity to protect your own interests in connection with your proposed investment in the Company. Do you intend to have a "purchaser representative" advise you in order to meet this requirement?

Yes _____ No _____

If yes, please furnish the information indicated below:

Name: ________________
Firm: ________________
Address: ________________
Telephone: ________________

In accordance with federal and state securities laws, your representative must satisfy the following conditions:

(1) He or she may not be an affiliate, director, officer or other employee of the Company or a beneficial owner of ten percent or more of any class of the equity securities of the Company, except where you are:

(i) A relative of the representative by blood, marriage or adoption not more remote than first cousin;

(ii) A trust or estate in which the representative and any persons related to him or her as specified in clause (i) above or clause (iii) below collectively have more than fifty percent of the beneficial interest (excluding contingent interest) or of which the representative serves as trustee or executor or in any similar capacity; or

(iii) A corporation or other organization of which the representative and any persons related to him or her as specified in clause (i) or (ii) above collectively are the beneficial owners of more than fifty percent of the equity securities (excluding directors' qualifying shares) or equity interests; and

(2) The representative must have such knowledge and experience in financial and business matters that he or she is capable of evaluating, alone or together with your other representatives or together with you, the merits and risks of the prospective investment in the Company.

If you are engaging a Purchaser Representative, your subscription cannot be accepted by the Company until you furnish to the Company a copy of a completed and signed Purchaser Representative Questionnaire and Investor Acknowledgement in the form of Appendix II to the Subscription Agreement. That document must be dated prior to the date of your subscription.

To the best of my knowledge and belief, the above information supplied by me is true and correct in all respects. I agree that I will notify the Company immediately of any material change in any of the foregoing information prior to consummation of my purchase of Shares. I understand that the information being furnished in this Questionnaire is required to enable the Company to determine whether offers and sales to me of Shares of the Common Stock of the Company may be made without registration under federal and state securities laws.

Date: ___________

____
Signature

____
(Print name)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 6 Note

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Overview

This Chapter deals with various matters on which corporate management or shareholders may need legal advice following organization of the corporation and issuance of its securities.

Counsel's role in these matters depends on the relationship with the corporate client. Often, the initial engagement contemplates only services in forming the corporation. Even so, the organizers usually expect the attorney to play a continuing role, and to keep them advised as to matters necessary to keep the corporation's affairs in order.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 6-A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

A. General Considerations for Corporate Counsel

1. [6:1] Clarifying Role as Legal Counsel
2. [6:1.1] Privilege and Work Product Concerns
    a. [6:1.2] Corporate waiver of privilege—impact on officers, employees, etc.
3. [6:2] Ethical Concerns
    a. [6:3] Professional duty owed to *corporate entity;* warning to individuals
        (1) [6:3a] Avoiding "taking sides"
        (2) [6:3.1] Special problem in dealing with closely held corporation—confidential relationships between counsel and shareholders
        (3) [6:3.2] Impact in subsequent adversarial proceedings—counsel *not* disqualified
        (4) [6:3.5] Special duties of counsel for public corporations
        (5) [6:3.5a] Compare—counsel's "due diligence" undertaking in securities offerings
        (6) [6:3.5b] Compare—no dual representation of corporation and directors in shareholders' derivative suit
    b. [6:3.6] Representing corporate personnel
        (1) [6:3.7] Consent by board, appropriate official or shareholders
            (a) [6:3.8] Dispute in two-shareholder corporation
            (b) [6:3.9] Representation of "deadlocked" corporation—consent of all directors required
            (c) [6:3.10] Ethical concerns in shareholder derivative actions
    c. [6:4] Management decisions involving violations of law
        (1) [6:4.2] Compare—duty of counsel for public corporations to report securities law violations
4. [6:5] CCP § 473(b) Mandatory Relief From Default Upon In-House Counsel's Affidavit of Fault

1. [6:1] **Clarifying Role as Legal Counsel:** Avoid any uncertainty as to your continuing responsibilities to the corporation. After formation is completed, meet with management and discuss the matters as to which corporations routinely require legal assistance (as covered in this Chapter). You will generally find management expects you to assume the role of "general counsel" and to handle such matters for the corporation. In any event, come to some agreement as to the scope of your responsibility; and follow this up with a letter to the corporate client, confirming your understanding of the scope and nature of your undertaking and your fee arrangements.

2. [6:1.1] **Privilege and Work Product Concerns:** As long as you are providing *strictly legal services* to the corporation, the attorney-client privilege (Ev.C. § 950 et seq.) and work product protection (CCP § 2018.010 et seq.) apply to written memoranda, correspondence and communications between you and the corporate client, or in furtherance of your legal services to the corporation, during the course of your professional relationship; they also protect the confidentiality of communications between you and corporate personnel (not simply officers and directors) who "speak for the corporation." [See Ev.C. § 952; CCP § 2018.030; *Costco Wholesale Corp. v. Sup.Ct. (Randall)* (2009) 47 C4th 725, 733-736, 101 CR3d 758, 764-766; *Zurich*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

American Ins. Co. v. Sup.Ct. (Watts Indus., Inc.) (2007) 155 CA4th 1485, 1496-1504, 66 CR3d 833, 839-846; *Laguna Beach County Water Dist. v. Sup.Ct. (Woodhouse)* (2004) 124 CA4th 1453, 1458-1459, 22 CR3d 387, 391-392—attorney's audit response letters to client's outside accountants are protected work product]

However, these protections may be *lost* if you step out of your role as legal advisor, endeavoring to provide services of a nonlegal *business* nature. [See *Montebello Rose Co., Inc. v. Agricultural Labor Relations Bd.* (1981) 119 CA3d 1, 31-37, 173 CR 856, 873-877 (attorney acting as labor negotiator); *Watt Indus., Inc. v. Sup.Ct. (Sternberg)* (1981) 115 CA3d 802, 805, 171 CR 503, 504 (attorney acting as business agent in negotiations re real estate deal); see also *Los Angeles County Bd. of Supervisors v. Sup.Ct. (ACLU of Southern Calif.)* (2016) 2 C5th 282, 296, 212 CR3d 107, 115 (noting privilege inapplicable when attorney acts as negotiator for client or provides business advice)]

Whether communications made in the course of *combined* legal and nonlegal services enjoy the protections of the attorney-client privilege and work product doctrine depends on the "dominant purpose" of the communication. [See *Montebello Rose Co., Inc. v. Agricultural Labor Relations Bd.*, supra; see also *Federal Trade Comm'n v. Boehringer Ingelheim Pharmaceuticals, Inc.* (DC Cir. 2018) 892 F3d 1264, 1268—privilege applies where "legal advice was one of the significant purposes of the communications"]

a. [6:1.2] **Corporate waiver of privilege—impact on officers, employees, etc.:** Ordinarily, the corporation is the holder of the attorney-client privilege and has sole power to waive it. [See *Melendrez v. Sup.Ct. (Special Elec. Co., Inc.)* (2013) 215 CA4th 1343, 1353-1354, 156 CR3d 335, 343]

Consequently, communications between corporate counsel and a corporate insider (officer, director, employee) may be subject to disclosure and admitted into evidence in an action, including a criminal case, against the insider where the corporation waives the privilege with respect to such communications. However, under federal law, an insider (including an ostensible "consultant" or other "outsider" so intimately involved with the corporation as to be a "functional employee") may avert such waiver by showing a *joint* privilege. To establish a joint privilege, the insider must show:

- They *approached counsel for the purpose of seeking legal advice;*
- They made clear to counsel that they were seeking legal advice in an *individual* rather than *in* a representative capacity;
- Counsel saw fit to represent the insider *personally*, knowing a conflict could arise;
- The communications with counsel were *in confidence; and*
- The communications did *not concern matters within the corporation or its general affairs*. [*United States v. Graf* (9th Cir. 2010) 610 F3d 1148, 1156-1164]

3. [6:2] **Ethical Concerns:** Once formed (and assuming you continue on as legal counsel), the *corporate entity* is your client, rather than the individuals who employed you to form it. Of course, in representing the corporation, you will work primarily with its executive officers and directors. Yet, you must remember that your responsibility is to the corporate *entity* and *all* its constituent parts (shareholders, officers, directors, etc.) and not just to the corporate personnel with whom you deal and have developed a relationship. [See generally, CRPC 1.13(a)]

a. [6:3] **Professional duty owed to *corporate entity; warning to individuals:*** If it appears that the corporate interests may be adverse to those of the particular corporate personnel with whom you are dealing, you must protect the *corporation* (your client, ¶ 6:2).

Explain to the individuals involved that your professional responsibility and allegiance are owed to the corporate *entity*—not to the corporate officers, directors or shareholders (so-called *"Upjohn* warning," after *Upjohn Co. v. United States* (1981) 449 US 383, 101 S.Ct. 677). Advise them to seek independent counsel to protect their potentially adverse interests. [CRPC 1.13(f); see *La Jolla Cove Motel & Hotel Apts., Inc. v. Sup.Ct. (Jackman)* (2004) 121 CA4th 773, 784, 17 CR3d 467, 475 (citing text); *United States v. Nicholas* (CD CA 2009) 606 F.Supp.2d 1109, 1115-1117 (rev'd on other grounds (9th Cir. 2009) 583 F3d 600, 607)—law firm that represented both corporation and CFO in past matters was remiss in allowing CFO to believe firm was again representing corporation *and him* during investigation of corporate insiders' unlawful stock options (*Upjohn* warning "woefully inadequate under the circumstances")]

Compare: Former CRPC 3-600(D), the predecessor to current CRPC 1.13(f), cautioned that a lawyer must not mislead corporate constituents into believing that they may give the attorney "confidential" information that will not be disclosed or used to the corporation's benefit if the corporate interests are or become adverse to their own. While this warning does not appear in current CRPC 1.13(f), it remains sound advice and indeed follows from the language of CRPC 1.13(f) that "a lawyer representing the organization shall explain the identity of the lawyer's client whenever the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituent(s) with whom the lawyer is dealing."

(1) [6:3a] **Avoiding "taking sides":** Since corporate counsel's professional duties run to the corporation, they must refrain from taking part in any controversies or factional differences among the directors or shareholders (e.g., disputes over control of the corporation) so as to be able to continue to advise the *corporation* without actual or apparent bias. [*Goldstein v. Lees* (1975) 46 CA3d 614, 622, 120 CR 253, 258; *In re Davis* (Rev.Dept. 2003) 4 Cal. State Bar Ct.Rptr. 576, 592]

(2) [6:3.1] **Special problem in dealing with closely held corporation—confidential relationships between counsel and shareholders:** As a practical matter, corporate counsel may find it difficult to treat a *closely held* corporation, with relatively few shareholders, as an entity completely distinct from its shareholders: "Instances in which the corporation attorneys stand in a *fiduciary relationship to individual shareholders* are obviously more likely to arise where the number of shareholders is small … [T]he corporate attorneys, because of their close interactions with a shareholder or shareholders, simply stand in confidential relationships in respect to *both* the corporation and individual shareholders." [*Skarbrevik v. Cohen, England & Whitfield* (1991) 231 CA3d 692, 705, 282 CR 627, 635-636 (emphasis added; internal quotes and citation omitted); see *La Jolla Cove Motel & Hotel Apts., Inc. v. Sup.Ct. (Jackman)* (2004) 121 CA4th 773, 785, 17 CR3d 467, 475 (citing text)]

Even so, neither the existence of confidential relationships with individual shareholders, nor the fact that the attorney's representation of the corporation benefits individual shareholders, by itself, means the attorney *represents* the shareholders. The *corporate entity* remains the client, and the shareholders cannot properly presume corporate counsel is protecting their individual interests. [*La Jolla Cove Motel & Hotel Apts., Inc. v. Sup.Ct. (Jackman)*, supra, 121 CA4th at 784, 17 CR3d at 475; *Skarbrevik v. Cohen, England & Whitfield*, supra—corporate attorney owed no duty to nonclient minority shareholder in arranging elimination of preemptive rights to allow majority shareholders to increase their ownership; see *Sprengel v. Zbylut* (2019) 40 CA5th 1028, 1042-1048, 253 CR3d 561, 571-576—50% owner of LLC had no reason to believe LLC's attorneys were acting to protect her own personal interests; *Responsible Citizens v. Sup.Ct. (Askins)* (1993) 16 CA4th 1717, 1726-1732, 20 CR2d 756, 761-765 (*discussed at ¶ 1:11.5a ff.*)—attorney representing partnership not necessarily in attorney-client relationship with individual partner for purposes of disqualification rules]

Indeed, except in *alter ego* situations, an attorney may simultaneously represent, in unrelated matters, both a corporation and another client with interests adverse to the corporation's sole corporate shareholder; *see ¶ 1:11.5g*.

➪ [6:3.1a] ***PRACTICE POINTER:*** To make sure individual shareholders do not mistakenly assume you are looking out for their personal interests in handling a transaction for the corporation, expressly disclaim *in writing* any such undertaking and urge them to seek the advice of independent counsel.

(3) [6:3.2] **Impact in subsequent adversarial proceedings—counsel *not disqualified:*** In the event of an adversarial transaction (or, in the worst scenario, a lawsuit) between the corporation and one or more of its officers, directors or shareholders, corporate counsel may be called upon to represent the corporation against the very individuals with whom they previously dealt at the corporate level. The fact counsel may have learned confidential information about these individuals in the course of representing the corporation does *not* disqualify counsel from continuing to represent the corporation. [See *Meehan v. Hopps* (1956) 144 CA2d 284, 293, 301 P2d 10, 14—director/stockholder whose position required divulgence of information to corporate counsel could not disqualify counsel from representing corporation in subsequent suit against director]

[6:3.3 - 6:3.4] ***Reserved.***

(4) [6:3.5] **Special duties of counsel for public corporations:** *See discussion at ¶ 5:12.15 ff.*

(5) [6:3.5a] **Compare—counsel's "due diligence" undertaking in securities offerings:** *See discussion at ¶ 5:12.5 ff.*

(6) [6:3.5b] **Compare—no dual representation of corporation and directors in shareholders' derivative suit:** *See discussion at ¶ 6:612*.

b. [6:3.6] **Representing corporate personnel:** A lawyer representing a corporation may also represent any of its directors, officers, shareholders or employees, *provided* it will not adversely affect the interests of the others *and each client consents in writing* after consultation as to the implications of such multiple representations (i.e., the potential conflicts, advantages and risks involved). [See CRPC 1.13(g); *and ¶ 1:9 ff.*; compare *United States v. Talao* (9th Cir. 2000) 222 F3d 1133, 1140-1141—corporate attorney cannot counsel corporation and employee who proposes to accuse corporation of criminal conduct in testimony before grand jury; *Gong v. RFG Oil, Inc.* (2008) 166 CA4th 209, 216, 82 CR3d 416, 422, *discussed at ¶ 1:11.2a*]

(1) [6:3.7] **Consent by board, appropriate official or shareholders:** The corporation's consent should, of course, be given by the board of directors or by some authorized official *other than* the individual(s) to be represented by corporate counsel. Alternatively, the consent may be given by the *shareholder(s)*. [CRPC 1.13(g); *In re Davis* (Rev.Dept. 2003) 4 Cal. State Bar Ct.Rptr. 576, 593]

(a) [6:3.8] **Dispute in two-shareholder corporation:** Where one of a corporation's two shareholders sues both the corporation and the second shareholder over corporate policy (e.g., reinvestment vs. distribution of corporate profits), consent to joint representation of the corporation and the second shareholder (who is also the president with authority to retain and oversee counsel) may be given by the second shareholder in their capacity as *shareholder*. (Consent as an "authorized official" is not adequate because the president is also the person to be represented; *see* ¶ 1:11.2a ff.) [Cal. State Bar Form.Opn. 1999-153]

(b) [6:3.9] **Representation of "deadlocked" corporation—consent of all directors required:** *See ¶ 1:11.1e*.

(c) [6:3.10] **Ethical concerns in shareholder derivative actions:** *See ¶ 6:612 ff.*

c. [6:4] **Management decisions involving violations of law:** Ordinarily, of course, you must implement decisions made by corporate management no matter how much you doubt their prudence or utility. However, if you know of conduct that is (1) *illegal* and may be reasonably imputable to the corporate client, or (2) likely to cause the corporation substantial injury, your professional responsibility to the corporate entity requires that you take affirmative measures on its behalf. You should seek reconsideration of the decision or review by higher corporate authority, even by the board of directors if warranted. Where, despite your efforts, management persists in such conduct, you may resign. [CRPC 1.13(b), (d); see CRPC 1.13(e)—directors must be informed of lawyer's resignation]

➪ [6:4.1] ***CAVEAT:*** In the above situations (¶ 6:4), you may *not* violate your duty to protect all confidences to which the attorney-client privilege is otherwise applicable (see Bus. & Prof.C. § 6068(e))—i.e., you cannot blow the whistle on your client. [CRPC 1.13(c); see *United States v. Quest Diagnostics Inc.* (2nd Cir. 2013) 734 F3d 154, 163-165—in-house counsel violated duty of confidentiality to client under New York professional conduct rule by participating as plaintiff in qui tam action against his former employer alleging False Claims Act violations]

(1) [6:4.2] **Compare—duty of counsel for public corporations to report securities law violations:** *See discussion at ¶ 5:12.15 ff.*

4. [6:5] **CCP § 473(b) Mandatory Relief From Default Upon In-House Counsel's Affidavit of Fault:** A court must set aside a default, default judgment or dismissal entered against a party if the party's attorney files a timely affidavit essentially accepting fault for the default or dismissal (unless the court finds that the default or dismissal was not in fact attributable to the attorney). [CCP § 473(b)]

The CCP § 473(b) mandatory relief provision applies where *in-house* counsel was at fault … even when the in-house counsel was also an *officer* of the corporate client. So long as counsel was acting in the capacity of an attorney, the neglect is *not* imputed to the corporate client. [*Gutierrez v. G & M Oil Co., Inc.* (2010) 184 CA4th 551, 561, 108 CR3d 864, 872-873 (citing text)—"representing clients *in court* is the quintessential *legal* service performed by an attorney, in-house or outside" (emphasis in original); see also *Missakian v. Amusement Indus., Inc.* (2021) 69 CA5th 630, 647-648, 285 CR3d 23, 33-34 (citing text)]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 6-B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

B. Shareholder Meetings and Actions

- 1. [6:7] What Constitutes Shareholder Action
  - a. [6:8] "Approval by shareholders"
  - b. [6:9] "Approval by outstanding shares"
    - (1) [6:10] Compare—ratification?
  - c. [6:11] Compare—action by written consent
    - (1) [6:11a] Limitation—election of directors
  - d. [6:11.1] Shares disqualified from voting
- 2. [6:12] Matters Involving Shareholder Action
  - a. [6:13] Annual election of directors
    - (1) [6:13.1] Director qualifications
    - (2) [6:14] Election at shareholders' meeting
      - (a) [6:15] Cumulative voting limitation
    - (3) [6:16] Election by written consent
  - b. [6:18] Election to fill vacancy on board
    - (1) [6:18.1] Compare—vacancies resulting from removal of directors
    - (2) [6:19] Special election if majority of board appointed
  - c. [6:20] Removal of directors
    - (1) [6:21] Limitation to protect cumulative voting rights
    - (2) [6:22] Limitation to protect class voting rights
  - d. [6:23] Amendment of articles
    - (1) [6:24] Class or series affected by amendment
    - (2) [6:25] Statutes requiring supermajority approval
      - (a) [6:26] Change to close corporation or nonprofit status; making shares assessable
      - (b) [6:27] Amendments re existing close corporations
      - (c) [6:27.1] Certain SPC amendments
      - (d) [6:27.2] Certain benefit corporation amendments
      - (e) [6:27.3] Imposing supermajority requirements
  - e. [6:28] Adoption, amendment or repeal of bylaws
    - (1) [6:29] Limitation—changing size of board
    - (2) [6:31] Compare—shareholder amendments vs. amendments by directors
  - f. [6:32] Other fundamental changes in corporate structure
    - (1) [6:36] Compare—close corporations
  - g. [6:37] Transactions between corporation and officers or directors

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- (1) [6:38] Loans or guarantees
  - (a) [6:39] Shareholder approval requirements
  - (b) [6:40] Exceptions
  - (c) [6:42] Compare—corporations having at least 100 shareholders
- (2) [6:43] “Interested” director contracts
- (3) [6:46] Indemnification of officers, directors

3. Shareholder Action at Meetings
- a. [6:47] When meetings required
  - (1) [6:48] Annual meeting for election of directors
    - (a) [6:49] Transaction of other business
      - 1) [6:50] Notice required
    - (b) [6:51] Annual financial report due before meeting
      - 1) [6:52] No effect on meeting requirement
    - (c) [6:54] Counsel's role in preparing for meeting
    - (d) [6:56] Remedy for failure to hold meeting
      - 1) [6:56.1] Court's authority limited
  - (2) [6:57] Special meetings of shareholders
    - (a) [6:58] Who may call special meetings
    - (b) [6:60] Procedure for calling special meeting
      - 1) [6:61] Requirements as to form and content of call
    - (c) [6:62] Obligation of corporation to comply
      - 1) [6:63] Time requirements
      - 2) [6:64] Remedy for failure to comply
      - 3) [6:66] Access to shareholder list
- b. [6:67] Place of shareholder meetings
- c. [6:67.5] Virtual shareholder meetings
  - (1) [6:67.6] Shareholder consent requirements for virtual meetings
- d. [6:68] Notice of meeting
  - (1) Content of notice
    - (a) [6:70] Date, hour and place
      - 1) [6:70.1] Virtual or remote participation
    - (b) Re annual meetings
      - 1) [6:71] Management nominees for directors
      - 2) [6:72] Other matters
      - 3) [6:73] Limitation—matters requiring unanimous approval if not specified
    - (c) [6:74] Re special meetings
  - (2) [6:76] Manner of giving notice
    - (a) [6:77] Address for notice
    - (b) [6:78] Procedure where no address available
      - 1) [6:79] Comment
      - 2) [6:79.1] Address problems
    - (c) [6:79.2] Electronic notices
      - 1) [6:79.3] Notices during emergency
      - 2) [6:79.4] Inability to send electronically
  - (3) [6:80] Time notice deemed given
    - (a) [6:81] Proof of notice
  - (4) [6:82] Amount of notice required
  - (5) [6:83] When notice of adjournment required
  - (6) [6:84] Waiver of notice

(a) [6:85] Failure to object as waiver
(b) [6:86] Formal waivers
1) [6:87] Contents
e. [6:88] Record date for shareholder notice or action
(1) [6:89] By resolution of directors
(2) [6:90] Without resolution of directors
(a) [6:91] If notice waived
(b) [6:92] Adjourned meetings
(3) [6:93] Compare—action taken without meeting
(4) [6:94] Compare—record date for other purposes
(5) [6:95] Effect of share transfer after record date
f. Determination of voting rights
(1) [6:96] Which shares entitled to vote
(a) [6:97] Comment
(2) [6:98] Which persons entitled to vote
(a) [6:99] Shares held by fiduciaries
1) [6:99.1] Exception—shares held by issuer as fiduciary
(b) [6:100] Shares held by pledgees, receivers, etc.
(c) [6:101] Shares held by minors
(d) [6:102] Shares held in several names
(e) [6:102.1] Shares held by corporations
(f) [6:102.2] Shares held by subsidiaries
g. [6:103] Proxies
(1) [6:104] When proxies may be compelled
(2) [6:105] What constitutes valid proxy
(a) [6:106] Corporations with 100 or more shareholders
(b) [6:107] Election of directors—withheld votes
1) [6:107.1] Effect
(c) [6:108] Federal rules
(3) [6:108.5] *FORMS*
(4) [6:109] Duration of proxy
(5) Revocability of proxy
(a) [6:110] Revocation by shareholder
(b) [6:111] Revocation on death or incapacity of shareholder
(c) [6:112] When irrevocable
(d) [6:114] Irrevocable proxy revoked upon transfer of shares
(6) [6:115.1] Proxy contest expenses
(a) [6:115.2] Shareholders or directors may authorize reimbursement
1) [6:115.3] Reimbursement of insurgents
2) [6:115.4] Reimbursement of management
(b) [6:115.5] Compare—court may not order reimbursement
(c) [6:115.6] Compare—federal rules
h. [6:116] Quorum required for meeting
(1) [6:117] Exception—lesser quorum at court-ordered meetings
(2) [6:118] Articles may permit one-third quorum
(3) [6:119] Effect of lack of initial quorum
(a) [6:120] Adjourned meetings; notice requirement
(4) [6:121] Effect of loss of quorum
(a) [6:122] Example

- i. Vote required for shareholder action at meeting
  - (1) [6:123] Majority vote generally
    - (a) [6:124] Example
    - (b) [6:125] Effect of abstentions
    - (c) [6:126] Limitation—majority of quorum required
  - (2) [6:127] Supermajority vote requirements
    - (a) [6:128] By articles of incorporation
    - (b) [6:129] By statute
    - (c) [6:132] By close corporation shareholders' agreement
  - (3) [6:133] Shareholders' right to split votes
  - (4) [6:134] Cumulative voting for directors
    - (a) [6:135] Purpose
    - (b) [6:136] Statutory right
      - 1) [6:137] Which corporations
      - 2) [6:138] Which elections
      - 3) [6:139] Statutory provisions
      - 4) [6:141.2] Exception—“listed” corporations
      - 5) [6:141.3] Exception—statutory close corporations
    - (c) [6:142] Procedure to obtain cumulative voting
    - (d) [6:143] Mechanics of cumulative voting
      - 1) [6:144] Cumulative voting formula
    - (e) [6:145] Secret ballots; when required
    - (f) [6:145.1] Shareholder deadlock; provisional directors
- j. [6:146] Procedure at meeting
  - (1) [6:147] Chair
  - (2) [6:148] Agenda
  - (3) [6:149] Election inspectors
    - (a) [6:150] Function
    - (b) [6:151] Number of inspectors
    - (c) [6:152] Duty of good faith
  - (4) [6:153] Recording minutes
- k. [6:153.1] Shareholders' right to be informed of voting results
  - (1) [6:153.2] “Shareholders” who may make request
    - (a) [6:153.3] Certain beneficial owners excluded
  - (2) [6:153.4] Applicable to California shareholders of foreign corporations
  - (3) [6:153.5] Compare—beneficial owners' right to voting information

4. [6:153.10] Shareholder Suit to Challenge Election of Director
   - a. [6:153.11] Challenge not restricted to technical or procedural grounds
   - b. [6:153.12] Standing not limited to shareholders of record
   - c. [6:153.13] Procedure
5. [6:154] Shareholder Action by Written Consent
   - a. [6:155] Number of shares required
     - (1) [6:156] Compare—action at shareholders' meeting
     - (2) [6:157] Example
     - (3) [6:158] Unanimous consent required for election of directors
       - (a) [6:159] Compare—filling vacancy on board
   - b. [6:160] Record date for shareholders' consents
   - c. [6:162] Form of consent
     - (1) [6:163] Compare—proxy rules

d. [6:164] Electronic consent permitted
e. [6:165] Right to revoke consent
f. [6:166] Notice required to nonconsenting shareholders
(1) [6:166.1] What constitutes "prompt notice"
(2) [6:167] Matters requiring notice *before* action taken
6. [6:169] Compare—Controlling Shareholder Action; Fiduciary Limitations

[6:6] Corporations normally function through their boards of directors, rather than their shareholders. But there are a number of matters upon which shareholder action or approval is required or permitted (*see* ¶ *6:12 ff.*).

1. [6:7] **What Constitutes Shareholder Action:** On matters as to which shareholder action is either "required" or "permitted," the applicable statutes require "*approval by shareholders*" or "*approval by the outstanding shares*." These are important terms and have different statutory definitions:

a. [6:8] **"Approval by shareholders":** When the Code uses this term, it means the matter must be approved or ratified by vote of a majority (or any greater percentage required by the articles or particular statutes) of the shares *represented and voting* at a shareholders' *meeting* at which a quorum is present. The shares voting for approval must also constitute a majority of the quorum (*see* ¶ *6:116*). [Corps.C. § 153; *see* ¶ *6:123 ff.* re "shares represented and voting"]

b. [6:9] **"Approval by outstanding shares":** When the Code uses this term, it means approval at a shareholders' *meeting* by a majority (or any greater percentage required by the articles or particular statute) of *all* outstanding shares in each class or series *entitled* to vote—which, of course, may be greater than those present and voting at the meeting. [Corps.C. § 152]

(1) [6:10] **Compare—ratification?** While Corps.C. § 153 "approval by shareholders" (¶ 6:8) expressly includes after-the-fact ratification, Corps.C. § 152 "approval by outstanding shares" does not. There is no apparent reason for this distinction and, presumably, § 152 "approval" should be construed to include ratification as well.

c. [6:11] **Compare—action by written consent:** Corporate action may also be "approved by the shareholders" or "approved by the outstanding shares" by written consent. In other words, shareholders can act *without a meeting* (*see* ¶ *6:154*). However, shareholder action by written consent always requires approval by a majority (or greater percentage required by the articles or statute) of *all shares entitled to vote*. [Corps.C. § 194—"vote" includes "written consent"; Corps.C. §§ 153, 603(a); *see* ¶ *6:154 ff.*]

(1) [6:11a] **Limitation—election of directors:** Shareholders cannot elect directors without a meeting except by *unanimous* written consent (unless to fill a vacancy *not* resulting from removal, in which case the written consent of a majority of the outstanding shares suffices; *see* ¶ *6:18 ff.*). [Corps.C. §§ 305(b), 603(d); *see* ¶ *6:158 ff.*]

d. [6:11.1] **Shares disqualified from voting:** Whenever shares are disqualified from voting on any matter, they are not counted in determining a quorum (i.e., they are not considered outstanding shares) and may not vote at any meeting to approve such matter. [Corps.C. § 112]

2. [6:12] **Matters Involving Shareholder Action:** The only action *required* to be taken by the shareholders on a *regular* basis is the annual election of directors (Corps.C. § 600(b)).

Otherwise, shareholder action is relatively infrequent. Shareholders may initiate action without prior board action (e.g., removal of directors, or adopting or amending bylaws). But, normally, shareholder action occurs only *after* the board of directors has taken or proposed certain major actions for which shareholder approval is required as a matter of law.

a. [6:13] **Annual election of directors:** By statute, shareholders are *required* to meet annually for the election of directors, on a date and at a time specified in the bylaws. [Corps.C. § 600(b); *see* ¶ *6:48*] (Exception: The articles may provide for less than one-year director terms to permit an *interim* election pursuant to a "voting shift"; *see* ¶ *3:114 ff., 4:65*.)

All directors stand for election at each annual meeting; i.e., there are no staggered terms. (Exceptions: Articles or bylaws may provide staggered terms for directors of "listed" corporations (¶ *4:77a ff.*) and mutual water companies (¶ *3:148.3*).) But the articles may provide for "class voting"—one or more directors elected exclusively by holders of shares of a certain class or series. [Corps.C. § 301(a); *see* ¶ *3:155*]

Such election normally takes place at a formal meeting; but as discussed below (¶ 6:16 ff.), it may also be accomplished without a meeting, by unanimous written consent of all shareholders entitled to vote for directors. [Corps.C. § 603(a), (d)]

(1) [6:13.1] **Director qualifications:** While California corporate law imposes no qualifications for directors, the bylaws may do so (e.g., requirement that director also be shareholder; *see* ¶ *4:78, 4:278*). [Cf. Corps.C. § 318—Secretary of State registry of "distinguished women and minorities" available to serve on corporate boards of directors]

Cross-refer: "Independence" requirements for directors of "listed" corporations are discussed at ¶ *4:278.1*.

(2) [6:14] **Election at shareholders' meeting:** The election of directors at a shareholders' meeting is by "plurality" vote—i.e., the candidates receiving the highest number of affirmative votes are elected; votes against a director and abstentions (withheld votes) have no effect. [Corps.C. § 708(c)]

(a) [6:15] **Cumulative voting limitation:** If *cumulative voting* for directors is requested, election requires whatever number of shares is derived using the cumulative voting formula. [Corps.C. § 708(b); *see* ¶ *3:151*]

(However, "listed" corporations may eliminate cumulative voting for directors; *see* ¶ *4:88.13 ff.*)

(3) [6:16] **Election by written consent:** Unless prohibited by the articles, directors can also be elected *without* any meeting, by shareholder written consents. But this method of election requires the *unanimous* written consent of all shares entitled to vote for directors. [Corps.C. § 603(d); *see* ¶ *6:158*]

• [6:17] **Comment:** Requiring unanimous consent protects the rights of any shareholder so entitled to demand cumulative voting for directors at a shareholders' meeting (¶ *6:134*).

b. [6:18] **Election to fill vacancy on board:** Vacancies on the board of directors resulting from *resignation, death, etc.* are normally filled by appointments by the remaining directors. But if they fail to act, the shareholders are empowered to fill such vacancies on the board. [Corps.C. § 305(b)]

In such cases, shareholders may act by majority vote at a duly held meeting, or by written consent of a majority of the outstanding voting shares. [Corps.C. § 305(b)]

(1) [6:18.1] **Compare—vacancies resulting from removal of directors:** Vacancies on the board resulting from *removal of one or more directors during their term* (*see* ¶ *6:234*) cannot be filled by the remaining directors, unless the articles or bylaws adopted by the shareholders specifically authorize them to do so. Such vacancies can only be filled by "approval of the shareholders" (¶ *6:8*) or by unanimous written consent of all outstanding shares entitled to vote. [Corps.C. §§ 305(a), (b), 603(d)]

(2) [6:19] **Special election if majority of board appointed:** If the number of vacancies occurring during a year is so large that a majority in office at any time was appointed by the other directors, rather than elected by the shareholders, the holders of *5%* or more of the shares have the right to call a *special meeting* of shareholders to elect a new board of directors. (Alternatively, such shareholders may apply to the superior court for an order calling a special shareholders' meeting for this purpose.) [Corps.C. § 305(c)]

c. [6:20] **Removal of directors:** The shareholders also have the power to remove any or all of the directors from office at any time without cause. Such removal requires "*approval by outstanding shares*"; i.e., not simply a majority of those present at a shareholders' meeting, but a majority of all shares outstanding entitled to vote for directors (Corps.C. § 152, ¶ *6:9*). [Corps.C. § 303(a); *see* ¶ *6:235*]

(1) [6:21] **Limitation to protect cumulative voting rights:** But the majority cannot oust from office a director who is supported by shareholders entitled to representation on the board under cumulative voting: i.e., unless the *entire* board is removed (necessitating election of a new board), no individual director can be removed if the shares voting against removal would have been sufficient to elect them using cumulative voting. [Corps.C. § 303(a)(1); *and see* ¶ 6:139, 6:236] This is so even in the case of "listed" corporations that have eliminated cumulative voting and established staggered terms for directors. [Corps.C. § 303(a)(3); *and see* ¶ *3:148 ff.*]

(2) [6:22] **Limitation to protect class voting rights:** Likewise, where there is "class voting" (i.e., a class or series of shares entitled to elect one or more directors; *see* ¶ *3:155*), a director representing a particular class or series cannot be removed except by the applicable vote of shares of that class or series. [Corps.C. § 303(a)(2)]

d. [6:23] **Amendment of articles:** "Approval by the outstanding shares" (Corps.C. § 152, ¶ *6:9*) is required to amend the articles of incorporation. [Corps.C. § 902(a); *see* ¶ *8:54*]

(1) [6:24] **Class or series affected by amendment:** In addition, if any class or series of shares would be affected thereby, the proposed amendment must be approved by a majority of *that class* or series. (This applies whether the change is for better or worse, and even if the class or series is not otherwise entitled to vote.) [Corps.C. § 903; see also Corps.C. § 3000 (SPCs); *and* ¶ *8:56*]

(2) [6:25] **Statutes requiring supermajority approval:** By statute, more than a simple majority approval is required for certain article amendments.

(a) [6:26] **Change to close corporation or nonprofit status; making shares assessable:** Except for mutual water companies, *unanimous* approval by the holders of all classes of outstanding shares is required to become a close corporation or a nonprofit corporation; or to make the shares assessable. [Corps.C. §§ 158(b), 904, 911(c); *see* ¶ *8:61, 8:64, 8:65*]

(b) [6:27] **Amendments re existing close corporations:** Approval by at least *two-thirds* of each class of shares is required for articles amendments that would revoke close corporation status, or change the authorized maximum shareholders in a close corporation. (The articles, however, may deny a vote to any class or authorize amendments by a lesser percentage, but not less than a majority of the outstanding shares.) [Corps.C. § 158(c); *see* ¶ *8:62*]

(c) [6:27.1] **Certain SPC amendments:** Approval by at least *two-thirds* of each class is also required for amendments that would change the corporation into a social purpose corporation (SPC, ¶ *9:56*) or revoke SPC status (¶ *9:276 ff.*); or that would materially alter any special purpose of an SPC (¶ *9:262*). [Corps.C. §§ 911(d)(2), 3000(b), 3002(c)]

Approval by *all* of the outstanding shares of all classes is required for an amendment that would change an SPC into a nonprofit corporation. [Corps.C. § 3001(c)]

(d) [6:27.2] **Certain benefit corporation amendments:** Approval by at least *two-thirds* of each class is likewise required for amendments that would change a corporation into a benefit corporation (¶ 9:531 ff.) or revoke benefit corporation status (¶ 9:661 ff.). [Corps.C. §§ 14603(a), 14604; see Corps.C. § 14601(d)(1)]

(e) [6:27.3] **Imposing supermajority requirements:** If the amendment imposes supermajority approval requirements for a corporation with *100 or more* shareholders (subject to exemption for certain “nonreporting” corporations with multiple classes of stock), it must be approved by such supermajority. [Corps.C. § 710; *see* ¶ *4:115.2 ff.*]

e. [6:28] **Adoption, amendment or repeal of bylaws:** Usually, the original bylaws are adopted by the incorporators or directors before any shares are issued. Once shares are issued, bylaws can be adopted, amended or repealed either by the board of directors or by “approval of the outstanding shares” (Corps.C. § 152, ¶ *6:9*). [Corps.C. § 211; *see* ¶ *4:177*]

(1) [6:29] **Limitation—changing size of board:** Where the number of directors is not specified in the articles, it will have to be specified in the bylaws (Corps.C. § 212(a); *see* ¶ *4:172*). After shares are issued, such bylaws cannot be changed by the directors alone—i.e., amendments changing the number of directors require “approval of the outstanding shares.” [Corps.C. § 212(a); *see* ¶ *4:182*]

Further, to preserve the cumulative voting rights of minority shareholders, a bylaw *reducing* the number of directors *to fewer than five* cannot be adopted if the votes cast against its adoption at a meeting, or the shares not consenting in the case of an action by written consent, are more than 16-2/3% of the outstanding shares entitled to vote. (Thus, shareholders with more than *16-2/3%* of the voting shares are protected from losing representation on the board.) [Corps.C. § 212(a)]

[6:30] ***Reserved.***

(2) [6:31] **Compare—shareholder amendments vs. amendments by directors:** Other than the limitation against reducing the size of the board (¶ 6:29), there are *virtually no restrictions* on the shareholders' power to adopt or change the bylaws.

In contrast, the power of the board of directors to change the bylaws may be limited by the articles or bylaws themselves; *see* ¶ *4:181*. [Corps.C. § 211]

f. [6:32] **Other fundamental changes in corporate structure:** Shareholder approval is required to effect certain other fundamental changes in the corporate structure. For example:

- *Sale* or other transfer of all or substantially all of the corporation's assets. [Corps.C. § 1001 (¶ *8:589*); see also Corps.C. §§ 3100 (SPCs, ¶ *9:302*), 14603(d) (benefit corporations, ¶ *9:651*)]

- *Merger* or corporate *reorganization*. [Corps.C. §§ 1113 (¶ *8:210.13 ff.*), 1200-1201 (¶ *8:173*), 14603(b) (¶ *9:535 ff.*); see also Corps.C. §§ 3200-3203 (SPCs, ¶ *9:314*)]

- *Conversion* into another form of entity. [Corps.C. §§ 1152(b) (¶ *8:471 ff.*), 14603 (¶ *9:535 ff.*); see also Corps.C. §§ 3301(a)(2), 3302(b) (SPCs, ¶ *9:322*); Corps.C. § 14604(c) (benefit corporations, ¶ *9:535 ff.*)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- *Voluntary dissolution*. [Corps.C. § 1900 (*¶ 8:758*)]

[6:33 - 6:35] ***Reserved.***

(1) [6:36] **Compare—close corporations:** By written agreement, the shareholders of a close corporation may generally confer upon its management the power to effect such transactions *without approval* by the directors or shareholders. [Corps.C. § 300(b), (c); *see ¶ 3:248*]

But there are specified circumstances under which shareholder approval may be required. (E.g., dissolution, reorganization; *see ¶ 3:259*.)

g. [6:37] **Transactions between corporation and officers or directors:** To limit potential breaches of fiduciary duty to the shareholders, their approval is required for various transactions in which the directors or officers have financial interests:

(1) [6:38] **Loans or guarantees:** Corporate loans, or corporate guarantees of loans made by third parties, require approval by a "majority of shareholders entitled to act" where they are made to:

- Any *officer or director* (or of its "parent corporation," as defined in Corps.C. § 175); [Corps.C. § 315(a), (c); *see ¶ 6:473 ff.*]

- Any other borrower, where the loan is non-recourse and *secured by shares of the corporation* or its parent … unless the loan is "otherwise adequately secured," or is made pursuant to an employee stock purchase or option plan (*see ¶ 6:40*). [Corps.C. § 315(c), (f)(1); *see ¶ 6:483*]

(a) [6:39] **Shareholder approval requirements:** *See ¶ 6:473 ff.*

(b) [6:40] **Exceptions:** There are several statutory exceptions to these requirements:

- **Advances for expenses:** See Corps.C. § 315(d), *discussed at ¶ 6:478*.

- **Employee stock purchase loans:** See Corps.C. §§ 315(f)(1), 408, *discussed at ¶ 6:475*.

- **Loans from other employee benefit plans:** See Corps.C. § 315(a), *discussed at ¶ 6:475.1*.

- **Certain other loan transactions:** See Corps.C. § 315(f)(1), (3), *discussed at ¶ 6:478.1*.

[6:41] ***Reserved.***

(c) [6:42] **Compare—corporations having at least 100 shareholders:** Greater flexibility is allowed to corporations having 100 or more shareholders: Shareholder approval for loans or loan guarantees to officers and directors is not required if:

- A duly adopted *bylaw* authorizes the board alone to make such loans and guarantees; *and*

- The board approves the loan or guarantee without counting the vote of the interested officer or director; *and*

- The board determines that the loan or guarantee can reasonably be expected to benefit the corporation. [Corps.C. § 315(b); *¶ 6:476*]

(2) [6:43] **"Interested" director contracts:** Contracts or transactions in which a director has a material financial interest (direct or indirect) may be validated by *either:*

- Full disclosure to and approval by a disinterested board of directors (*see* ¶ *6:296, 6:297.5*); *or*

- "Approval of the shareholders" (Corps.C. § 153, *¶ 6:8*) *excluding* any shares held by the interested director (*¶ 6:294*). [Corps.C. § 310(a)(1), (2); *see detailed discussion at ¶ 6:286 ff.*]

[6:44 - 6:45] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(3) [6:46] **Indemnification of officers, directors:** An employee or agent of the corporation may be indemnified for liability and expenses incurred in litigation based on their performance of duties for the corporation. Such indemnification may be made *either* by the board of directors, or by "approval of the shareholders" (Corps.C. § 153, *¶ 6:8*), *excluding* any shares owned by the person to be indemnified. (Alternatively, indemnification may be ordered by the court in which a proceeding against such agent or employee is pending; *see ¶ 6:463*.) [Corps.C. § 317(e)(4); *see detailed discussion at ¶ 6:436 ff.*]

Caution: The extent to which the board of directors or shareholders of an *SPC* must approve indemnification is unclear; *see ¶ 9:136 ff.*

3. Shareholder Action at Meetings

a. [6:47] **When meetings required:** A shareholders' meeting is required once a year for the election of directors (annual meetings); and at any other time a meeting has been properly called (special meetings).

(1) [6:48] **Annual meeting for election of directors:** Every California corporation is required to hold an annual meeting of shareholders to elect directors. The meeting must be held on a date and at a time "stated in or fixed in accordance with the bylaws …" [Corps.C. § 600(b)]

• [6:48.1] **Joint shareholder/board meeting:** If the shareholders and directors are one and the same (or nearly so), it may be convenient for them to notice and hold a *joint* annual meeting. At such a joint meeting, the shareholders first elect the directors and take any other desired action. The directors so elected then appoint the corporate officers and conduct other appropriate business (*¶ 6:191*). Joint minutes may be prepared.

(a) [6:49] **Transaction of other business:** The only business that is obligatory at the annual shareholders' meeting is the election of directors. But "any other proper business" may also be transacted. [Corps.C. § 600(b)]

1) [6:50] **Notice required:** If the board of directors intends (when the meeting notice is given) to present such other matters to the shareholders, it should include them in the meeting notice, along with the nominees for directors. [Corps.C. § 601(a); *see ¶ 6:72*]

(b) [6:51] **Annual financial report due before meeting:** By statute, an annual financial report must be provided to the shareholders at least *15 days before* the annual meeting (35 days if sent by third-class mail) and no later than *120 days after the close of the corporation's fiscal year*. [Corps.C. § 1501(a); see also Corps.C. § 3500(a), (c) (SPCs); *and ¶ 6:540 ff.*]

(Remember that the bylaws of corporations with fewer than 100 shareholders of record, as determined under Corps.C. § 605, may *waive* the annual report requirement (per Corps.C. § 1501(a), ¶ 6:540), though it appears that this waiver provision does *not* apply to SPCs (*see ¶ 9:189.1*).)

1) [6:52] **No effect on meeting requirement:** Delays or difficulties in furnishing the financial report do *not* extend the date or excuse the requirement for holding an annual shareholders' meeting. [Corps.C. § 1501(a)(2); see also Corps.C. § 3500(c) (SPCs)]

Cross-refer: For requirements as to form, content and delivery of the annual financial report to shareholders, *see ¶ 6:540 ff.*

[6:53] *Reserved.*

(c) [6:54] **Counsel's role in preparing for meeting:** It is appropriate for the lawyer representing the corporation to remind management that an annual shareholders' meeting is required, and to assist with preparations for such meeting.

➪ [6:55] ***PRACTICE POINTER:*** Set up a tickler file in your office for the annual meeting dates of each corporation you represent. About 60 days before each scheduled meeting, send the executive officers a letter reminding them of the requirement that an annual shareholders' meeting be held, and proposing an agenda.

This is a good opportunity to cement your relationship with the corporate client: Before the meeting, review the corporation's activities during the year with the executive officers to determine whether its records are up to date. You may find that corporate actions requiring shareholder approval are being contemplated, or have already taken place and need to be ratified.

Clients are often unaware of the need to obtain formal shareholder approval of particular transactions, and may be relying on you to bring such matters to their attention.

• ***FORM:*** Reminder Letter for Annual Shareholders' Meeting, *see Form 6:A*.

(d) [6:56] **Remedy for failure to hold meeting:** If the annual meeting is not held within 60 days after the date designated in the bylaws (or, if no date is so designated, within 15 months after the corporation was organized or had its last annual meeting), *any shareholder* may apply to the superior court for an order that such meeting be held. [Corps.C. § 600(c)]

Such an order may be granted "summarily" after notice to the corporation giving it opportunity to be heard. The order may specify appropriate matters, including: the date, time and place for the meeting; the record date for determining shareholders entitled to notice; and the form of notice to be given. [Corps.C. § 600(c)]

(The voting shares represented in person or by proxy at a court-ordered meeting *constitute a quorum* for purposes of such meeting—notwithstanding any provision of the articles or bylaws or statutes to the contrary. Corps.C. § 600(c); *see ¶ 6:117*.)

1) [6:56.1] **Court's authority limited:** However, the court's authority under Corps.C. § 600(c) extends only to "the mechanical aspects of holding the annual shareholders meeting." Thus, e.g., § 600(c) does not authorize a court to order payment of dissident shareholders' proxy expenses. [*Johnson v. Tago* (1986) 188 CA3d 507, 515, 233 CR 503, 507]

(2) [6:57] **Special meetings of shareholders:** Special meetings of the shareholders shall be held whenever properly "called" (i.e., requested by an authorized person or persons). There is no limit on the number or frequency of such meetings.

(a) [6:58] **Who may call special meetings:** Special meetings of shareholders may be called at any time by:

• The board or its chairperson (¶ 6:262);

• The president of the corporation;

• The holders of *at least 10%* of the outstanding voting shares; or

• Any other person designated in the corporation's articles or bylaws. [Corps.C. § 600(d)]

[6:59] **Note:** A special rule allows the holders of *at least 5%* of the voting shares to call a special meeting for election of directors where a majority of the board has been *appointed* by the other directors, rather than elected to office by the shareholders. [Corps.C. § 305(c); *see ¶ 6:19*]

(b) [6:60] **Procedure for calling special meeting:** A call for special meeting of shareholders may be directed to either the chairperson of the board, the president, any vice-president or the secretary of the corporation. [Corps.C. § 601(c)]

1) [6:61] **Requirements as to form and content of call:** The Code does not specify the form or content of such call. However, most *bylaws* require a *written* request by the person or persons calling the meeting, specifying the *general nature of the business proposed* to be transacted at the meeting (*see ¶ 4:206*).

The purpose of this requirement is to enable the corporation to send out a proper Notice of Special Meeting, since such Notice must contain a statement of the business to be conducted (*see ¶ 6:74*).

• ***FORM:*** Call for Special Meeting of Shareholders, *see Form 6:B*.

(c) [6:62] **Obligation of corporation to comply:** Where a special shareholders' meeting is called other than by the board of directors, the officer receiving the request (chairperson of board, president, vice-president or secretary) must notify the shareholders accordingly. [Corps.C. § 601(c)]

1) [6:63] **Time requirements:** Such notice must be given within *20 days* after receipt of the request. And, the meeting date must be set not less than *35*, nor more than *60 days* after receipt of the request. [Corps.C. § 601(c)]

2) [6:64] **Remedy for failure to comply:** If the corporation fails to send out such notice within the time specified above (¶ 6:63), the person or persons calling the meeting may *send out the notice themselves*. [Corps.C. § 601(c)]

Alternatively, they may apply to the superior court for an order directing the corporation to do so. After at least 10 business days' notice to the corporation, the court may "summarily" issue such order. The order may designate such matters as the time and place of meeting, the form of notice to be given, and the record date for determining the shareholders entitled to vote. [See Corps.C. § 601(c)]

[6:65] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

3) [6:66] **Access to shareholder list:** If the persons requesting the meeting want to give the notice of the meeting themselves, they are entitled to do so (¶ 6:64). For this purpose, they will need access to the mailing addresses of all shareholders. This purpose clearly entitles the shareholder to inspection rights under Corps.C. § 1600(a); *see* ¶ *6:522*.

b. [6:67] **Place of shareholder meetings:** Shareholders' meetings are to be held at whatever place (inside or outside California) is stated in or fixed in accordance with the corporation's bylaws (*see* ¶ *4:198*). If the bylaws contain no such provision, shareholders' meetings are to be held at the "principal office of the corporation." [Corps.C. § 600(a)]

[6:67.1 - 6:67.4] ***Reserved.***

c. [6:67.5] **Virtual shareholder meetings:** In lieu of meeting at one physical location, a shareholders meeting may be conducted, in whole or in part, by "electronic transmission by and to the corporation," electronic video screen communication, conference telephone, or "other means of remote communication" (*¶ 4:199.5 ff.*) *provided* the corporation implements reasonable measures to:

• provide shareholders (in person or by proxy) a reasonable opportunity to *participate* in the meeting (including an opportunity to read or hear the proceedings in *real time* as they occur) and to *vote* on matters submitted for shareholder vote;

• *record* any shareholder vote or other action taken by electronic, telephonic, or other "remote" means; *and*

• verify that each person who has voted remotely is a shareholder or proxyholder. [Corps.C. § 600(e)]

(1) [6:67.6] **Shareholder consent requirements for virtual meetings:** An entirely virtual shareholder meeting may be held if at least one of the following conditions apply:

• All shareholders consent;

• The board determines a virtual meeting is necessary or appropriate because of an emergency (¶ 6:187.7); *or*

• Notwithstanding the absence of shareholder consent, the meeting is conducted on or before December 31, 2025, and includes a live audiovisual feed for the meeting's duration. In this circumstance, in addition to providing an audiovisual feed, the corporation may offer an audio-only feed provided the choice of which feed to use is made by the shareholder and the corporation does not impose any barriers to either means of participation. [Corps.C. § 600(e) (amended Stats. 2023, Ch. 115; eff. 1/1/24)]

A de minimis disruption of an audio or audiovisual feed does not require a corporation to end the shareholder meeting or render it out of compliance with the remote meeting requirements. [Corps.C. § 600(e)]

d. [6:68] **Notice of meeting:** All shareholders entitled to vote are entitled to written notice of the shareholders' meeting. This applies to both special meetings and the regular annual meeting. (Neither the articles nor the bylaws may dispense with notice of the annual meeting.) [Corps.C. § 601(a)]

➪ [6:69] ***PRACTICE POINTER:*** In practice, shareholder meetings of smaller corporations are often held without formal notice. Instead, the shareholders simply provide written waivers of notice at or after the meeting (*see* ¶ *6:86*).

However, if there is any possibility of disagreement among the shareholders, it is a good idea to *give formal notice* in advance of the meeting. This will prevent any dissident shareholder from delaying or blocking shareholder action by refusing to provide the waiver of notice.

(1) Content of notice

(a) [6:70] **Date, hour and place:** The notice must specify the date, hour and place of the meeting. (This applies to annual meetings as well as to special meetings of the shareholders, and even if the time and place for the annual meeting is specified in the bylaws.) [Corps.C. § 601(a)]

1) [6:70.1] **Virtual or remote participation:** If applicable, the notice must also specify the means of electronic transmission by and to the corporation, electronic video screen communication, conference telephone, or other means of remote communication by which shareholders may participate in the meeting. [Corps.C. § 601(a); *see* ¶ *4:199.5 ff.*]

(b) Re annual meetings

1) [6:71] **Management nominees for directors:** For any meeting at which directors are to be elected (which is the case at each annual meeting of shareholders), the notice must state the names of the nominees the board intends (at the time of the notice) to present for election. [Corps.C. § 601(a)]

2) [6:72] **Other matters:** Any other matters the board of directors intends (at the time the notice is mailed) to present for action at the meeting should also be specified in the annual meeting notice. [Corps.C. § 601(a)]

But failure to state such other matters in the annual meeting notice will not prevent the shareholders from considering and acting upon those other matters at the annual meeting (subject to the limitations noted in the following paragraph). [Corps.C. § 601(a)]

3) [6:73] **Limitation—matters requiring unanimous approval if not specified:** There is an important restriction on shareholder action on matters not specified in the annual meeting notice. If the action involves any of the following matters, and its general nature was not stated in the notice of meeting or any written waiver thereof (¶ 6:84), the *unanimous* vote of all shareholders entitled to vote is required for approval of the following transactions:

• "Interested" director transactions (Corps.C. § 310, *see* ¶ *6:292*);

• Amendments to the articles of incorporation (Corps.C. § 902, *see* ¶ *8:54*);

• Conversion into another entity (Corps.C. § 1152, *see* ¶ *8:451*);

• Corporate reorganization (Corps.C. § 1201, *see* ¶ *8:173*);

• Voluntary dissolution (Corps.C. § 1900, *see* ¶ *8:758*); or

• A liquidating distribution inconsistent with preferred share preferences (Corps.C. § 2007, *see* ¶ *8:947*). [Corps.C. § 601(f)]

• ***FORM:*** Notice of Annual Meeting of Shareholders, *see Form 6:C*.

(c) [6:74] **Re special meetings:** In the case of special meetings of shareholders, the notice *must specify* the general nature of the business to be transacted. Unlike the annual meeting (¶ 6:71 ff.), *no other business* may be transacted at a special shareholders' meeting unless *all* shareholders provide written *waivers* of notice (¶ 6:84 ff.). [Corps.C. § 601(a)]

➪ [6:75] ***PRACTICE POINTER:*** This is a fertile area for dispute. Shareholders often attack actions taken at a shareholders' meeting on the ground the notice failed to advise them sufficiently of the matters to be considered.

While the statute requires only that the notice state the "general nature" of the proposed actions to be presented for approval at the meeting, it is a good idea for the notice to set forth the purposes in reasonable detail. This will generally prevent subsequent disputes as to the adequacy of the notice.

• ***FORM:*** Notice of Special Meeting of Shareholders, *see Form 6:D*.

(2) [6:76] **Manner of giving notice:** If a corporation has less than 500 shareholders of record as of the record date for the meeting, notice of a shareholders' meeting must be given either in person, by electronic transmission (e.g., fax or email, *see* ¶ 4:199.8 ff., *4:216.1 ff.*) or by *first-class* mail. [Corps.C. § 601(b)(1)]

If a corporation has 500 or more shareholders of record as of the record date for the meeting, the meeting notice may also be sent by third-class mail or any other means of written communication. [Corps.C. § 601(b)(1)]

(a) [6:77] **Address for notice:** If not given personally, the notice must be addressed to the shareholder at the address (e.g., street address, email address, or fax number) that appears in the corporation's books or the shareholder provided to the corporation. [Corps.C. § 601(b)(1)]

(b) [6:78] **Procedure where no address available:** If there is no address in the corporate records and the shareholder did not give one, then the notice may be (i) addressed to the shareholder at the corporation's principal office, or (ii) published at least once in a newspaper of general circulation in the county where the principal office is located. [Corps.C. § 601(b)(1)]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) [6:79] **Comment:** Neither procedure is likely to provide actual notice. But the statute does not require the corporation to "go looking" for its shareholders (i.e., the statute does *not* require affirmative efforts to locate a shareholder for the purpose of giving such notice).

2) [6:79.1] **Address problems:** If any properly addressed notice or report is returned to the corporation by the U.S. Postal Service and marked to indicate that it cannot be delivered to the shareholder at the address provided, the corporation does not have to send future notices or reports to the shareholder as long as the notices and reports are available to the shareholder upon written demand at the corporation's principal office for one year. [Corps.C. § 601(b)(2)]

(c) [6:79.2] **Electronic notices:** Notices sent by electronic transmission must comply with Corps.C. § 20 (¶ 4:199.8 ff.). [Corps.C. § 601(b)(3)]

1) [6:79.3] **Notices during emergency:** A corporation may send a shareholder meeting notice or any report electronically (¶ 4:199.8 ff.) if the board determines that it is necessary or appropriate because of an emergency (¶ 6:187.7). [Corps.C. § 601(b)(1)]

2) [6:79.4] **Inability to send electronically:** Unless there is an emergency (¶ 6:187.7), a corporation cannot send a meeting notice to a shareholder electronically if (i) the corporation was unable to deliver two consecutive notices by electronic means, or (ii) the corporation's secretary, assistant secretary, transfer agent, or any other person responsible for giving the notice knows that the corporation is unable to deliver the notice electronically. [Corps.C. § 601(b)(3)]

(3) [6:80] **Time notice deemed given:** Notice is deemed given when delivered personally, sent by fax or electronic transmission (in accordance with Corps.C. § 20, ¶ *4:199.8 ff.*), or deposited in the mail or sent by other means of written communication. [Corps.C. § 601(b)(1)]

(a) [6:81] **Proof of notice:** An affidavit of mailing, electronic transmission, electronic communication or other means of remote communication of the notice, executed by the corporate secretary (or any assistant secretary or the corporate transfer agent), is "prima facie evidence" of the giving of such notice. [Corps.C. § 601(b)(1)]

(4) [6:82] **Amount of notice required:** Written notice of the shareholders' meeting must be given not less than *10* nor more than *60 days* before the meeting—except if sent by third-class mail (*see* ¶ *6:76*), such notice must be given at least *30 days* before the meeting. [Corps.C. § 601(a)]

(5) [6:83] **When notice of adjournment required:** Unless the bylaws provide otherwise, notice of an adjourned shareholders' meeting is *not* required if the time and place thereof (or the means of electronic transmission by and to the corporation, electronic video screen communication, conference telephone, or other means of remote communication, if any, by which the shareholders may participate) are announced at the meeting, *unless:*

• The adjournment is for *more than 45 days*; or

• After the adjournment, the board fixes a new record date for the adjourned meeting. [Corps.C. § 601(d)]

In such cases, notice must be given to each shareholder of record entitled to vote at the adjourned meeting. [Corps.C. § 601(d); *see* ¶ *6:120*]

(6) [6:84] **Waiver of notice:** The required notice of a shareholders' meeting can be waived by any shareholder entitled to vote at the meeting. Similarly, if the notice given was defective in some way, the deficiency can be waived so as to validate actions taken at the meeting.

(a) [6:85] **Failure to object as waiver:** Shareholders *attending* a meeting (however noticed or called) are deemed to waive notice unless they *specifically object* at the *commencement* of the meeting to the transaction of business on the ground of improper notice. [Corps.C. § 601(e)]

But even if they make no objection at the outset, shareholders attending a meeting can still object to consideration of *matters required to be included in the notice* that were not so included. [Corps.C. § 601(e)]

(b) [6:86] **Formal waivers:** Shareholders not in attendance at the meeting can provide, *either before or after the meeting*, a written "waiver of notice or consent to the holding of the meeting or an approval of the minutes thereof." [Corps.C. § 601(e)]

1) [6:87] **Contents:** The waiver, consent or approval provided by the shareholders need *not* specify either the purpose of the meeting, or the business to be transacted, *unless* the action relates to one of the matters specified in Corps.C. § 601(f): i.e., approval of transactions in which directors have conflict of interest; amendment of articles; conversion;

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

reorganization; voluntary dissolution; or liquidating distributions contrary to preferred stock rights (*see* ¶ *6:73*). In these cases, the waiver must include "the general nature of the proposal." If not, any shareholder action requires *unanimous* approval by all shareholders entitled to vote. [See Corps.C. § 601(e), (f); *Ovadia v. Abdullah* (1994) 24 CA4th 1100, 1109-1110, 29 CR2d 527, 532-533; *and* ¶ *6:73*]

• ***FORM:*** Waiver of Notice and Consent to Holding of (Annual/Special) Meeting of Shareholders, *see Form 6:E*.

e. [6:88] **Record date for shareholder notice or action:** The shareholders who are entitled to notice and to vote at a shareholders meeting must be determined as of a "record date." The procedure to be followed is established by statute and may be set forth in the bylaws. [Corps.C. § 212(b)(7); ¶ *4:235*]

Such record date is fixed as follows:

(1) [6:89] **By resolution of directors:** The board of directors may set a record date between 10 days and 60 days before the shareholders' meeting. [Corps.C. § 701(a)]

(2) [6:90] **Without resolution of directors:** If fixed neither in the bylaws nor by resolution of the board, the "record date" for determining the shareholders entitled to notice and to vote at shareholder meetings is the close of business on the business *day before the notice* is given. [Corps.C. § 701(b)(1)] (As to when notice is deemed given, see Corps.C. § 601(b), ¶ *6:80*.)

(a) [6:91] **If notice waived:** Similarly, when notice of the meeting is to be waived, the record date for determining which shareholders are entitled to vote at the meeting, and which must provide the written waiver of notice, is the business *day before the meeting* is held. [Corps.C. § 701(b)(1)]

(b) [6:92] **Adjourned meetings:** If the meeting is adjourned, the same record date for determining the shareholders entitled to notice and to vote applies, unless the board fixes a new record date for the adjourned meeting (and the board *must* do so if the adjournment is for more than 45 days). [Corps.C. § 701(c)]

(3) [6:93] **Compare—action taken without meeting:** Where the board does not set a record date for determining the shareholders who may execute a written consent to corporate action (in lieu of action at a shareholders' meeting), the record date is the day on which the *first such consent* is given. [Corps.C. § 701(b)(2); *see* ¶ *6:160*]

(4) [6:94] **Compare—record date for other purposes:** The record date for any other purpose (e.g., distribution of dividends) in situations where the board does not fix a record date is the close of business on the day the board of directors adopts a resolution relating to such matter, or the 60th day before the date of such other action, whichever is later. [Corps.C. § 701(b)(3)]

(5) [6:95] **Effect of share transfer after record date:** Unless the articles or a shareholders agreement provides otherwise, a transfer of shares after the record date does *not* entitle the transferee to receive notice, or to vote, or to receive dividends, or to exercise any other shareholder right—i.e., the shareholders of record on the record date alone are entitled to the benefit of all such shareholder rights *notwithstanding transfer* of their shares. [Corps.C. § 701(d)]

f. Determination of voting rights

(1) [6:96] **Which shares entitled to vote:** Unless the articles provide otherwise, all shares are created equal as to voting rights (i.e., each share, regardless of class or series, is entitled to vote on any matter submitted to a vote of the shareholders). [Corps.C. §§ 700(a), 203]

(a) [6:97] **Comment:** Therefore, as discussed in the chapter on Pre-Incorporation Planning, whenever several classes of shares are authorized and the organizers intend to restrict voting rights of one or more classes, such restrictions *must appear in the articles* (*see* ¶ *3:111*).

Nor is it enough that the articles simply state that a certain class or series is entitled to vote ("Class A shares have voting rights"). Rather, the articles must expressly *negate* voting rights in any other class or series that is not intended to have voting rights ("Class A shares have the sole and exclusive right to vote"; or "Class B shares shall be nonvoting"). Otherwise, all classes have equal voting rights (*see* ¶ *3:112*).

(2) [6:98] **Which persons entitled to vote:** Problems sometimes arise as to which of several parties having an interest in the shares is entitled to exercise the voting rights as to such shares. In general, the person or entity in whose name the shares are registered in the records of the corporation is entitled to vote such shares, even if other persons have an interest therein. Such other persons are not permitted to vote or to give a valid proxy as to such shares. [See Corps.C. §§ 702-704]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [6:99] **Shares held by fiduciaries:** Thus, any shares held of record in the name of a trustee, administrator, executor, guardian or other fiduciary may be voted only by the fiduciary. [See Corps.C. § 702(a)]

1) [6:99.1] **Exception—shares held by issuer as fiduciary:** Shares held by the issuing corporation (or its subsidiary) in a fiduciary capacity may *not* be voted on any matter except to the extent such shares are voted by (a) the trustor or beneficial owner having such a right, (b) the corporate fiduciary in accordance with the trustor's or beneficial owner's binding instructions, or (c) one or more cotrustees (other than the issuer) having the right to vote the shares. [Corps.C. § 703(c)]

(b) [6:100] **Shares held by pledgees, receivers, etc.:** Likewise, shares held in the name of a secured creditor or pledgee may be voted by such person. Shares held or controlled by a receiver may be voted by the receiver, even without transfer into the receiver's name, if the receiver is authorized by court order to vote such shares. [See Corps.C. § 702(b), (c)]

(c) [6:101] **Shares held by minors:** Shares held by a minor may be voted by the minor until the corporation has legal notice that a guardian of the minor's property has been appointed. [Corps.C. § 702(d)]

(d) [6:102] **Shares held in several names:** Shares held in the names of two or more persons, including fiduciaries (e.g., trustees), may be voted by *any* of them; i.e., whichever one votes binds those who do not. If they all vote, the majority controls, except if they are split evenly, the vote is split likewise. [Corps.C. § 704; see *Edwards v.Edwards* (1998) 61 CA4th 599, 603, 71 CR2d 653, 655—Corps.C. § 704 is more specific provision and hence overrides Prob.C. § 15620 general rule that trustees must act unanimously unless trust instrument provides otherwise]

(e) [6:102.1] **Shares held by corporations:** Shares held in the name of another corporation may be voted by any officer, agent or other person designated by its board of directors or in its bylaws; or in the absence of such designation, by the chairperson of the board, the president, any vice-president, or any person they may authorize. [Corps.C. § 703(a)]

(f) [6:102.2] **Shares held by subsidiaries:** Shares of a corporation owned by its subsidiary are *not* entitled to vote on any matter. [Corps.C. § 703(b)]

g. [6:103] **Proxies:** Every shareholder entitled to vote has the right to authorize others to vote their shares by proxy. [Corps.C. § 705(a)]

(1) [6:104] **When proxies may be compelled:** Normally, proxies are voluntary. But they may be compelled pursuant to voting trust or other shareholders' voting agreement. And, someone holding title to shares on behalf of another, or solely as security for an obligation owed by the other, may be compelled to give a proxy to the other unless they have agreed otherwise. [Corps.C. § 705(d)]

(2) [6:105] **What constitutes valid proxy:** A proxy must authorize another person or persons to vote the shareholder's shares. The shareholder need not manually sign the proxy; it is sufficient if the shareholder (or their attorney in fact) places the shareholder's name or other authorization on the proxy manually, or by typewritten, telegraphic, or electronic transmission or otherwise. A proxy may even be transmitted orally by telephone if it is submitted with information indicating the proxy was authorized by the shareholder (or the shareholder's attorney in fact). [Corps.C. § 178; ¶ *4:250 ff.*]

Any proxy purporting to be executed under the Corporations Code is "presumptively valid." [Corps.C. § 705(a)]

(a) [6:106] **Corporations with 100 or more shareholders:** There are additional requirements when proxies are solicited from 10 or more shareholders of a corporation having 100 or more record shareholders and which is not subject to the reporting requirements of the 1934 Act: The proxy form must afford the shareholder the opportunity to *choose* between *approval or disapproval* of each matter or group of matters intended to be acted upon at the meeting for which the proxy is solicited. It must also provide, "subject to reasonable specified conditions," that where the person solicited specifies a choice with respect to any such matter, the shares will be voted in accordance therewith. [Corps.C. § 604(a)]

(b) [6:107] **Election of directors—withheld votes:** Where proxies are solicited in connection with the election of directors, if a shareholder marks "withhold" or otherwise indicates they do not wish to vote for the named candidates, the proxy cannot be voted for their election. [See Corps.C. § 604(b)]

1) [6:107.1] **Effect:** Under traditional "plurality" voting, a negative or withheld vote has no effect: The candidates receiving the highest number of affirmative votes are elected. And where the election is *uncontested*, a candidate who receives *any* affirmative votes (even just one) is elected. (However, in the case of a "listed" corporation that requires election of directors by a *majority of the shares represented and voting at the meeting*, negative or withheld votes can prevent a director's election; *see ¶ 4:88.20 ff.*) [See Corps.C. §§ 708(c), 708.5]

(c) [6:108] **Federal rules:** Proxy solicitation is also regulated by federal law where the corporation is a 1934 Act reporting company (generally, shares are traded on a national securities exchange, or the corporation has total assets exceeding $10 million and either (i) 2,000 or more record shareholders or (ii) (if the corporation is not a bank or bank holding company) 500 or more record shareholders who are not "accredited" investors (¶ *5:174 ff.*)). [See SEA §§ 12(g), 14 (15 USC §§ 78*l*(g), 78n); see also SEC Reg. 14A]

[6:108.1 - 6:108.4] ***Reserved.***

(3) [6:108.5] ***FORMS:***

- Proxy (for use with corporations having fewer than 100 shareholders), *see Form 6:F*.
- Proxy (for use with corporations having 100 or more shareholders), *see Form 6:G*.

(4) [6:109] **Duration of proxy:** A proxy is valid for *whatever period of time is stated therein*, subject to the shareholder's right to revoke (¶ 6:110). [Corps.C. § 705(b)]

If *no* time period is stated in the proxy, it expires automatically *11 months* after execution. [Corps.C. § 705(b)]

(5) Revocability of proxy

(a) [6:110] **Revocation by shareholder:** Unless irrevocable (¶ 6:112), a proxy can be revoked by the shareholder who executed it any time before the shares are voted. Such revocation is effected either by:

- A *writing* delivered to the corporation stating that the proxy is revoked; or
- Executing a *new proxy* at a later date; or
- Simply *attending the meeting* for which the proxy was given and *voting* the shares personally. (Note: Such attendance revokes a proxy only for the meeting attended. An otherwise unexpired proxy continues in effect for later meetings not attended by the shareholder executing the proxy.) [Corps.C. § 705(b)]

(b) [6:111] **Revocation on death or incapacity of shareholder:** A proxy is not automatically revoked upon the death or incapacity of its maker. Rather, it remains valid until *written notice* of such death or incapacity is received by the corporation. Thus, any vote or shareholder action before such notice is received is not affected. [Corps.C. § 705(c)]

(c) [6:112] **When irrevocable:** A proxy that states it is "irrevocable" cannot be revoked for the period specified therein (even if the shareholder dies or becomes incompetent) if held by any of the following persons or their nominees (Corps.C. § 705(e)):

- A *pledgee* of the shares;
- Persons who have *contracted to purchase* the shares from the maker of the proxy, or who hold an *option* to purchase the shares;
- Persons who have *sold* a *portion* of their shares to the maker of the proxy;
- *Creditors* of the corporation, or of the shareholder, who extended or continued credit in *consideration* of being given the proxy—providing the proxy specifically so states and also states the name of the person extending or continuing such credit;
- Persons *employed* by the corporation pursuant to contract which provided for the giving of such proxy—providing the proxy specifically so states and also states the name of the employee and the period of employment contracted;
- Persons designated under a shareholders agreement or *voting trust* agreement under Corps.C. § 706;
- *Beneficiaries* of a trust with respect to shares held by the trustee;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Persons to whom the proxy was given "to *secure the performance of a duty or to protect a title*, either legal or equitable, until the happening of events which, by the terms of such proxy, discharge the obligations secured by it." [Corps.C. § 705(e)]

In each of the above cases, the proxy becomes revocable when the holder no longer is a pledgee, creditor, employee, etc.; or when the obligation for which the proxy was given is paid. [See Corps.C. § 705(e)]

[6:113] ***Reserved.***

(d) [6:114] **Irrevocable proxy revoked upon transfer of shares:** Even an irrevocable proxy may be revoked by a transferee of the shares who has *no knowledge* that an irrevocable proxy has been given, *unless* the existence of the proxy and its irrevocability appear on the certificate representing the shares (or the "initial transaction statement" if the corporation has adopted uncertificated shares; *¶ 5:472*). [Corps.C. § 705(f)] (It apparently makes no difference whether the transferee paid any consideration for the shares, as long as they had no knowledge of the proxy.)

➪ [6:115] ***PRACTICE POINTER:*** If you represent the person to whom an irrevocable proxy is given, the safest course is to recommend that your client hold the share certificate (i.e., as pledgee).

If this is impractical, you should recommend that a legend be *imprinted* upon the certificate itself (not merely attached thereto) stating both that an irrevocable proxy has been granted and the *reason* for its irrevocability (e.g., given as security for repayment of loan, as part of employment contract, etc.).

(6) [6:115.1] **Proxy contest expenses:** Proxy contests can be quite expensive for both the corporation and the insurgents. Proxy solicitations may result in substantial printing, mailing, telephone costs, etc., and legal fees. In the typical scenario, the corporation bears the expenses of defending management's proposals, and the insurgents bear their own expenses. But the insurgents may be able to obtain reimbursement from the corporation, as described below (¶ 6:115.2 ff.).

(a) [6:115.2] **Shareholders or directors may authorize reimbursement:** The shareholders or directors may authorize the corporation to reimburse *either side's* (management's or insurgents') proxy contest expenses (including attorneys' fees), so long as:

• The controversy involves *corporate policy* rather than *personnel* (e.g., management seeking to entrench itself in office); and

• The expenses are for *reasonable* solicitation activities and are reasonable in amount. [*Johnson v. Tago* (1986) 188 CA3d 507, 514-515, 233 CR 503, 506-507; *Braude v. Havenner* (1974) 38 CA3d 526, 532, 113 CR 386, 389]

1) [6:115.3] **Reimbursement of insurgents:** The shareholders or directors may authorize the corporation to repay the losing side's expenses; but this is rarely done. [*Johnson v. Tago* (1986) 188 CA3d 507, 514-515, 233 CR 503, 506-507]

Thus, as a practical matter, the insurgents' reimbursement depends on the outcome of the contest. If the insurgents prevail, the corporation may approve reimbursement in light of the benefit conferred. But if they lose, the corporation cannot be required to reimburse them (¶ 6:115.5).

2) [6:115.4] **Reimbursement of management:** In contrast, upon approval by the directors or shareholders, incumbent management can use the corporate treasury to pay proxy fight expenses *as incurred* (even if they eventually lose).

(b) [6:115.5] **Compare—court may not order reimbursement:** A *court* may not order a corporation to pay proxy contest expenses and attorneys' fees—this is solely for the corporation to decide. Courts may only determine whether the expenses recompensed were *reasonable*. [*Johnson v. Tago* (1986) 188 CA3d 507, 514-515, 233 CR 503, 506-507—court could not order corporation to pay insurgents' proxy contest expenses]

(c) [6:115.6] **Compare—federal rules:** Under the federal proxy rules, insurgents who intend to request the corporation to reimburse them for their expenses should so indicate in their proxy solicitation materials. [Reg. M-A, Rule 1007(c), 17 CFR § 229.1007(c) (applicable to proxy statements pertaining to mergers, consolidations, liquidations and asset sales)]

However, even if the insurgents prevail, the corporation is not obligated to reimburse them for their proxy expenses. Nor do they have a private right of action to recover their expenses … even though management's proxy materials were false or misleading in violation of the rules. [*Royal Business Group, Inc. v. Realist, Inc.* (1st Cir. 1991) 933 F2d 1056, 1061—corporation not required to reimburse proxy contestant who would not have waged contest had management disclosed probable merger; see SEA § 14(a) (15 USC § 78n(a)); SEC Rule 14a-9 (17 CFR § 240.14a-9)]

h. [6:116] **Quorum required for meeting:** Except as otherwise provided in the articles or by law (¶ 6:117 ff.), a *majority* of the shares *entitled to vote* must be represented, either in person or by proxy, to constitute a quorum at a shareholders' meeting. [Corps.C. § 602(a)]

For example, if there are 1,000 shares of voting common and 1,000 shares of nonvoting preferred stock outstanding, at least 501 common shares must be present (in person or by proxy) to take effective action at a shareholders' meeting. (The nonvoting preferred shares have no impact on quorum requirements.)

(Remember that shareholders not physically present in person or by proxy at a meeting may, by electronic transmission by and to the corporation, electronic video screen communication, conference telephone, or other means of remote communication (¶ *4:199.5 ff.*), be deemed present in person or by proxy, and may participate and vote at the meeting. See Corps.C. § 600(a), (e); ¶ *4:243.5, 4:265.1*.)

(1) [6:117] **Exception—lesser quorum at court-ordered meetings:** If the corporation fails to hold an annual shareholders' meeting for the election of directors, any shareholder may petition for a court order that such meeting be held (Corps.C. § 600(c), ¶ *6:56*). At any such court-ordered meeting, whatever voting shares are present constitute a quorum for the purposes of that meeting—even if *less* than a majority of the shares authorized to vote. [Corps.C. § 600(c); *see* ¶ *6:67.5 ff.* for discussion of virtual shareholder meeting requirements]

(2) [6:118] **Articles may permit one-third quorum:** The articles (not the bylaws) may authorize a lesser quorum—as few as *one-third* of the voting shares. [Corps.C. § 602(a)]

Compare: Note, however, that the articles may *not* require a quorum of *more* than a majority of the voting shares—except in a statutory close corporation (in which any number may be designated). [Corps.C. § 602(a); *and see* ¶ *3:262* re close corporations]

(3) [6:119] **Effect of lack of initial quorum:** In the absence of a quorum, no business may be transacted at a shareholders' meeting … except that the meeting may be *adjourned* to another date or time by a majority of the shares represented in person or by proxy. [Corps.C. § 602(c)]

(a) [6:120] **Adjourned meetings; notice requirement:** As discussed earlier, it is generally *not* necessary to notify all shareholders of an adjournment announced at a shareholders' meeting … *unless* the bylaws require it, or the adjournment is for more than 45 days, or the board of directors fixes a new record date for the adjourned meeting. [Corps.C. § 601(d); *see* ¶ *6:83*]

➪ [6:120.1] ***PRACTICE POINTER:*** As a practical matter, however, notice should be given to enhance the chances for obtaining a quorum at the rescheduled meeting.

On the other hand, a well-drafted proxy will typically appoint the proxy to vote at the scheduled meeting and at any "adjournment, postponement, or continuation" thereof. If the bulk of the shares are represented at the meeting by such proxies, re-noticing the meeting may not be necessary.

(4) [6:121] **Effect of loss of quorum:** If a quorum was present at the outset, the departure of some shareholders from the meeting does not necessarily prevent further shareholder action. The remaining shareholders can continue to transact business, *provided* that any action taken is approved by a majority of the shares required to constitute the quorum originally (or by the vote of a *greater* percentage, or by classes of shares, if required by the articles or the Code). [Corps.C. § 602(b)]

(a) [6:122] **Example:** Suppose there are 1000 shares of voting common outstanding, and 800 of these shares were represented at the opening of the meeting. Halfway through the meeting, the holders of 400 of these shares walk out. The holders of the remaining 400 shares can continue to take action. Although there is no longer a quorum (501 shares) present, any action supported by 251 shares (a majority of the shares required to constitute the original quorum) is effective. [See Corps.C. § 602(b)]

i. Vote required for shareholder action at meeting

(1) [6:123] **Majority vote generally:** Except as otherwise provided by statute or in the articles, the affirmative vote of a majority of the shares *present* and *voting* at a shareholders' meeting constitutes valid shareholder action. Of course, there must be a quorum present (*see* ¶ *6:116 ff.*); and the affirmative votes must also constitute a majority of such quorum (*see* ¶ *6:126*). [Corps.C. §§ 153, 602(a)]

(a) [6:124] **Example:** Suppose XYZ Corp. has 1000 voting shares outstanding, but only 600 shares are represented at a shareholders' meeting. If all 600 shares are voted, shareholder action will require at least 301 votes—i.e., a majority of those *present and voting*.

(b) [6:125] **Effect of abstentions:** However, if some shareholders abstain, fewer shares are required for shareholder action, because it requires only a majority of those present *and voting*. [See Corps.C. § 602(a)]

In the example above (¶ 6:124), if 500 of the 600 shares voted (with 100 abstaining), shareholder action would require only 251 votes.

(c) [6:126] **Limitation—majority of quorum required:** However, in no event can shareholder action at a meeting be taken by shares representing less than a majority of the quorum required for the meeting. [Corps.C. § 602(a)]

In the example above (¶ 6:124), if 200 of the 600 shares abstained, shareholder action could *not* be taken by a bare majority of the remaining 400 shares (201 votes). Because the quorum required for the meeting was 501 (a majority of the 1000 voting shares outstanding), *at least 251 shares* would have to support any shareholder action at the meeting. [See Corps.C. § 602(a)]

(2) [6:127] **Supermajority vote requirements:** Although, as stated, shareholder action may generally be taken by a majority of the shares present and voting at a meeting, a higher percentage is sometimes required:

(a) [6:128] **By articles of incorporation:** More than a simple majority vote is required for shareholder action where the articles of incorporation so provide. [Corps.C. § 602(a)]

Indeed, the articles may even require *unanimous* shareholder approval to constitute effective shareholder action. (Such provisions are frequently found in closely-held corporations; *see* ¶ 3:248 ff.)

(*Compare:* Note, however, that the articles may *not* provide for shareholder action on *less* than a majority vote; see Corps.C. § 602(a).)

(b) [6:129] **By statute:** Similarly, various *statutes* relating to specific shareholder actions may require a vote of more than a majority of the shares represented and voting at the meeting. For example:

• Shareholder approval of articles amendments and other fundamental changes requires a majority of all shares *entitled* to vote, not just those present and voting at the meeting; [Corps.C. § 902(a); ¶ 8:54 ff.]

• Amendment of the bylaws by the shareholders also requires action by a majority of all shares entitled to vote; [Corps.C. § 211; ¶ *4:184*]

• Election of a majority of directors may require approval by more than a majority of shares where cumulative voting is demanded. [Corps.C. § 708]

[6:130 - 6:131] ***Reserved.***

(c) [6:132] **By close corporation shareholders' agreement:** Special flexibility is afforded to the shareholders of a statutory close corporation. Notwithstanding the statutory standards (¶ 6:129) applicable to ordinary corporations, the shareholders of a statutory close corporation may enter into any agreement they wish as to how their voting rights shall be exercised, and may establish whatever voting requirements or procedures they choose, as long as these are set forth in the shareholders' written agreement. [Corps.C. § 300(b) & (c); *see* ¶ *3:243 ff.*]

(3) [6:133] **Shareholders' right to split votes:** A shareholder may vote only part of their shares and refrain from voting the balance. Or, the shareholder may even vote part for and part against any proposal (other than election of directors). [Corps.C. § 700(b)]

However, if a shareholder fails to specify the number of shares being voted, it is *conclusively presumed* that their vote applies to *all* shares they are entitled to vote. [Corps.C. § 700(b)]

(4) [6:134] **Cumulative voting for directors:** As with most other actions at a shareholders' meeting, directors can be elected by a majority of the shares present and voting … *unless* cumulative voting is requested by any shareholder entitled to vote. [Corps.C. § 708(b)]

(a) [6:135] **Purpose:** Cumulative voting tends to assure minority shareholders representation on the board of directors, and thus furthers "shareholder democracy." For this reason, it is strongly favored by public policy in California. [See

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Western Air Lines, Inc. v. Sobieski (1961) 191 CA2d 399, 413-414, 12 CR 719, 728; and *Wilson v. Louisiana-Pacific Resources, Inc.* (1982) 138 CA3d 216, 223, 187 CR 852, 857]

(b) [6:136] **Statutory right:** The right to cumulative voting in shareholder elections of directors exists as a matter of law. It need not specifically be provided for in the articles or bylaws. (Nor, except as to "listed" corporations (*see* ¶ *6:141.2*) or statutory close corporations (*see* ¶ *6:141.3*), can it be denied in the articles or bylaws; any such provision would be void as contrary to public policy.) [Corps.C. § 708(a)]

1) [6:137] **Which corporations:** Cumulative voting is available in shareholder elections for directors of any California corporation, and in any "pseudo-foreign" corporations as well. [*Wilson v. Louisiana-Pacific Resources, Inc.* (1982) 138 CA3d 216, 223, 187 CR 852, 857; *see* ¶ *3:5 ff.*]

2) [6:138] **Which elections:** The right to cumulative voting for directors is available in all elections for directors. [See Corps.C. § 708]

3) [6:139] **Statutory provisions:** Cumulative voting for directors is provided for in Corps.C. § 708, but is also protected by:

- Statutory requirement that all directors stand for election at the same time. [Corps.C. § 301; ¶ *6:13*]

- Statutory ban on removal of any director, if enough shares vote for their retention as would be required to elect the director under cumulative voting. [Corps.C. § 303(a)(1); ¶ *6:21*]

- Statutory ban on reducing number of directors to less than five if more than 1/6 of the voting shares object. [Corps.C. § 212(a); ¶ *6:29*]

[6:140 - 6:141.1] ***Reserved.***

4) [6:141.2] **Exception—"listed" corporations:** "Listed" corporations may eliminate cumulative voting by amending their articles (or bylaws) to so provide. [Corps.C. § 301.5; ¶ *4:88.13 ff.*] The above statutory provisions would still apply … *except that* the limitation on removal of directors (¶ *6:139*) would apply only if the "listed" corporation also established a classified board serving staggered terms. [Corps.C. § 303(a)(3); ¶ *4:77a ff.*]

5) [6:141.3] **Exception—statutory close corporations:** The shareholders of a statutory close corporation may, by their shareholders agreement, eliminate cumulative voting. [Corps.C. § 300(b), (c)]

(c) [6:142] **Procedure to obtain cumulative voting:** The right to cumulative voting is not automatic. Rather, at least one shareholder must give *notice* at the meeting of their intention to vote their shares cumulatively. Such notice must be given after the candidates' names have been placed in nomination and *before the voting begins*. [Corps.C. § 708(b)]

If any shareholder gives such notice, all other shareholders are also entitled to cumulate their votes. [Corps.C. § 708(b)]

(d) [6:143] **Mechanics of cumulative voting:** Cumulative voting gives each share as many votes as there are directors to be elected. The shareholder can then "cumulate" their votes by casting them all for one director, or distributing them as they see fit. As previously stated, this tends to assure minority representation on the board, as it prevents the holder of a simple majority of the shares from electing all of the directors. [Corps.C. § 708(a), (b)]

1) [6:144] **Cumulative voting formula:** The formula used under cumulative voting to determine the number of shares needed to elect a given number of directors is set forth at ¶ 3:151 ff.

(e) [6:145] **Secret ballots; when required:** Election for directors may be by voice vote, rather than written ballots, unless ballots are required in the corporation's bylaws, or a shareholder demands them at the meeting before the voting begins. [Corps.C. § 708(e)]

(f) [6:145.1] **Shareholder deadlock; provisional directors:** In the rare case where voting shares are evenly divided, and the shareholders are deadlocked and unable to elect a board of directors at the annual shareholders' meeting, the superior court may appoint one or more provisional directors to break the deadlock. The appointment may be made on petition of the holder(s) of *50%* of the voting power. The court can also order "such other equitable relief as … [it] deems appropriate." [Corps.C. § 308(b)]

- [6:145.2] **Comment:** Corps.C. § 308(b) refers to 50% of the voting power but presumably this means 50% *or more* of the voting power.

Cross-refer: For qualifications, duties and compensation of provisional directors, *see* ¶ *8:845 ff.*

j. [6:146] **Procedure at meeting:** In small, closely-held corporations, shareholder meetings are usually informal, with the minutes prepared in advance and simply submitted for approval. But in publicly-held corporations, or where there is disagreement among the shareholders, more formal procedures should be followed:

(1) [6:147] **Chair:** The bylaws usually provide who is to preside at meetings of the shareholders. (Typically, the chairperson of the board or the president of the corporation is so authorized.) Often, the attorney for the corporation is present and assists the presiding officer in conducting the meeting.

(2) [6:148] **Agenda:** The first order of business is to determine that a quorum of shares entitled to vote is present or represented by proxy at the meeting (*see ¶ 6:116*). Thereafter, minutes of the previous meeting or meetings may be presented and approved. The presiding officer then usually announces the various items of business to be voted upon by the shareholders (e.g., election of directors, etc.), and the order in which they will be acted upon. Following this, the presiding officer may determine the number of shares each shareholder or proxy holder is entitled to vote. (If election inspectors are appointed, their determinations will be utilized; *see* ¶ 6:149 ff.)

(3) [6:149] **Election inspectors:** The board of directors has discretion to appoint "inspectors of election" to act at any shareholders' meeting (regardless of whether an election of directors is to take place). If not so appointed by the directors, election inspectors *must* be appointed by the chairperson of any shareholders' meeting at the request of *any* shareholder or proxy holder at the meeting. [Corps.C. § 707(a)]

(a) [6:150] **Function:** The election inspectors determine the number of shares outstanding, their voting rights, the existence of a quorum, and the validity of any proxies presented at the meeting. The inspectors also receive and tabulate all votes, ballots or written consents; and hear and determine all challenges and questions arising in connection with the right to vote. They also determine when voting is terminated, the result of such voting, and do "such acts as may be proper to conduct the election or vote with fairness to all shareholders." [Corps.C. § 707(b)]

(b) [6:151] **Number of inspectors:** Either one or three election inspectors may be appointed by the board of directors. If appointed at the request of a shareholder or proxy holder, it is up to the majority of the shares present at the meeting to decide whether one or three inspectors should be appointed. [Corps.C. § 707(a)]

If there are three inspectors, the decision, act or certificate of a majority is effective in all respects as the decision, act or certificate of all. [Corps.C. § 707(c)]

(c) [6:152] **Duty of good faith:** The election inspectors are required to perform their duties impartially, in good faith, to the best of their ability, and as expeditiously as practical. [Corps.C. § 707(c)]

(4) [6:153] **Recording minutes:** A corporation is required to maintain records of shareholder meetings. [Corps.C. § 1500; *see ¶ 6:498*]

For this purpose, the bylaws usually provide that an officer of the corporation (ordinarily, the secretary or an assistant secretary) shall attend all shareholder meetings and take minutes thereof. The officer so designated may take notes or the meeting may be recorded for later transcription.

These minutes, together with copies of the notice of meeting or shareholder waivers thereof, are then filed in the minute book of the corporation. (A copy of such minutes, certified by the secretary or assistant secretary, is prima facie evidence that a meeting was held and that the matters stated in the minutes transpired; see Corps.C. § 314.)

• ***FORM:*** Minutes of (Annual/Special) Shareholders' Meeting, *see Form 6:H*.

k. [6:153.1] **Shareholders' right to be informed of voting results:** If a shareholder makes a written request to the corporation at any time that is no more than 60 days after *any* shareholders' meeting, the corporation must inform the shareholder of the result of any particular vote taken at the meeting. This includes, as to each class of shares voting, the number of shares voting for, against or abstaining from voting. If directors were elected at the meeting, the report must give the number of shares (or votes, if voted cumulatively) cast for each nominee for director. [Corps.C. § 1509]

(1) [6:153.2] **"Shareholders" who may make request:** Such reports may be requested by (1) shareholders of record; and (2) persons named as shareholders on the records of any central depository, bank or broker-dealer that is holding shares of the corporation (they need only provide the corporation with a photocopy of a statement or receipt from their depository showing that they are shareholders). [Corps.C. § 1512(a), (c)]

(a) [6:153.3] **Certain beneficial owners excluded:** However, beneficiaries of trusts or estates, or employees covered by pension, retirement or health care trusts or funds that hold shares of the corporation, are not similarly entitled to obtain

reports of voting results from the corporation. [Corps.C. § 1512(b)] (Compare: Certain beneficial owners are entitled to obtain voting information from the *shareholder of record; see ¶ 6:153.5*.)

(2) [6:153.4] **Applicable to California shareholders of foreign corporations:** California residents owning shares in *foreign* corporations qualified to do business in California (or having domestic or foreign subsidiaries so qualified) are also entitled to obtain voting results upon request, as outlined above (¶ 6:153.1 ff.). [Corps.C. §§ 1510, 1511]

(3) [6:153.5] **Compare—beneficial owners' right to voting information:** Certain beneficial owners of shares in domestic or foreign corporations held of record by others possessing the power to vote them (e.g., participants in employee stock ownership plans) are entitled to be informed as to how such shares were voted. The beneficial owner must make a "reasonable written request" to the holder of the power to vote the shares or a designated agent, and may be required to pay a "reasonable charge" for the disclosure. The holder of the power to vote the shares must maintain a record of how the shares were voted for at least 12 months after the vote. [Corps.C. § 711(d)]

[6:153.6 - 6:153.9] ***Reserved.***

4. [6:153.10] **Shareholder Suit to Challenge Election of Director:** Any shareholder, or "any person who claims to have been denied the right to vote" (*see ¶ 6:153.12*), can file a superior court action challenging the election or appointment of any director(s). The court has broad equitable power to fashion appropriate relief, including an order determining the person entitled to the office of director or ordering a new election or appointment. In deciding election contests, the court may also determine the validity, effectiveness and interpretation of voting agreements and trusts, the validity of share issuances, and the right of persons to vote. [Corps.C. § 709(a), (c); see *Haah v. Kim* (2009) 175 CA4th 45, 53-54, 95 CR3d 515, 521-522]

a. [6:153.11] **Challenge not restricted to technical or procedural grounds:** Proceedings under Corps.C. § 709 are equitable in nature; hence, the court may consider all matters necessary to determine the validity of the contested election. This includes challenges based on, e.g., breach of fiduciary duty and conflict of interest. [*Morrical v. Rogers* (2013) 220 CA4th 438, 450-460, 163 CR3d 156, 165-174]

b. [6:153.12] **Standing not limited to shareholders of record:** Standing to bring suit is not limited to the persons whose names appear as shareholders in the corporation's books. Rather, suit may be brought by anyone claiming a legal or equitable interest in corporate shares, including persons who entered into agreements to take corporate shares but who have not yet been issued those shares. Standing under Corps.C. § 709 is broad, allowing a court to consider the merits of the action *without first determining whether the party bringing the action in fact has a legal right to vote*. [*Haah v. Kim* (2009) 175 CA4th 45, 54-55, 95 CR3d 515, 522-523]

c. [6:153.13] **Procedure:** The complaint must be filed in the county where the corporation's principal office is located (or if none in this state, in Sacramento County). Upon filing of the complaint, the court must order a hearing to be held within *five days* (or later for "good cause shown"). Notice of the hearing date and a copy of the complaint must be served, in the same manner as a summons (unless the court directs service by registered mail), upon the person whose election or appointment is questioned and upon any other person whom plaintiff alleges was elected or appointed. [Corps.C. §§ 177, 709(b); see *Morrical v. Rogers* (2013) 220 CA4th 438, 460-464, 163 CR3d 156, 174-177—plaintiff shareholder in 3-shareholder corporation required to join 2 other shareholders as indispensable parties (per CCP § 389(a)(2)) because of their interests and alleged roles in challenged election]

5. [6:154] **Shareholder Action by Written Consent:** Unless otherwise provided in the articles, shareholder action can be taken without formal meetings by written consents provided by a sufficient number of shareholders. [Corps.C. § 603(a); see also Corps.C. § 194—"vote" includes "written consent" (¶ *6:11*)]

a. [6:155] **Number of shares required:** Any shareholder action, *except* election of directors (¶ 6:158), may be taken by written consents provided by the same number of shares as would be required for action taken at a meeting at which all shares *entitled* to vote were present and voting. [Corps.C. § 603(a)]

(1) [6:156] **Compare—action at shareholders' meeting:** The number of shares required to take action by written consent is greater, of course, than would be required to take action at a shareholders' meeting: i.e., at a meeting at which a quorum is present, shareholder action can be taken by a majority of those *present* and *voting*, which will usually be less than a majority of *all* shares entitled to vote. [Corps.C. § 602(a), ¶ *6:125*]

(2) [6:157] **Example:** XYZ Corp. has 1,000 voting shares outstanding. To act *without* a meeting, at least 501 shares would have to sign written consents (and more for election of directors; *see ¶ 6:158*). In contrast, at a *meeting*, shareholder action could be taken by a majority of those present and voting, as long as quorum requirements were satisfied; e.g., if only 501 of the 1,000 shares were represented at the meeting (i.e., a quorum), by as few as 251 shares.

(3) [6:158] **Unanimous consent required for election of directors:** The major exception to the above rule (¶ 6:155) is that election of directors by written consents requires approval by *all* shares entitled to vote. [Corps.C. § 603(d)] (The purpose is to protect each shareholder's right to cumulative voting for election of directors at shareholders' meetings; *see ¶ 6:136*.)

(a) [6:159] **Compare—filling vacancy on board:** But only a *majority* of the outstanding voting shares is required to fill a *vacancy* on the board (other than a vacancy created by removal) when the other directors have failed to do so. [Corps.C. §§ 305(b), 603(d); *see ¶ 6:18*]

b. [6:160] **Record date for shareholders' consents:** The record date for determining which shareholders are entitled to execute written consents, when the board has not previously acted on the matter, is the day the *first* such written consent is given. [Corps.C. § 701(b)(2)]

[6:161] On the other hand, if the corporate action has already been approved by the board, and shareholder approval is being sought by written consents, the record date is the *later* of (1) the close of business on the *day the board acted* or (2) the *60th day prior to the date of the corporate action*. [Corps.C. § 701(b)(3)]

c. [6:162] **Form of consent:** There are no statutory requirements as to the form of consent where the corporation has fewer than 100 shareholders of record.

But where the corporation has 100 or more shareholders of record, any written consent distributed to 10 or more shareholders must afford a *choice between approval and disapproval* of each matter or group of related matters intended to be acted upon, other than elections to office. (However, this does not apply to corporations with securities registered under SEA § 12 or exempt from registration under SEA § 12(g)(2) (exchange-listed securities, registered investment companies, certain state or federally regulated financial institutions, etc.).) [Corps.C. § 604(a), (d); SEA § 12(g)(2) (15 USC § 78*l*(g)(2))]

• ***FORM:*** Action by Written Consent of Shareholders (Corps.C. § 603), *see Form 6:I*.

(1) [6:163] **Compare—proxy rules:** The federal proxy-solicitation rules also apply to solicitation of shareholder consents; *see ¶ 6:108*.

d. [6:164] **Electronic consent permitted:** The written consent may be given by facsimile, telegraphic or other electronic transmission (e.g., email). [Corps.C. §§ 603(a), 195]

e. [6:165] **Right to revoke consent:** A shareholder may revoke their written consent by notice to the corporation any time before it has received sufficient consents from other shareholders to authorize the action proposed; but not thereafter. [Corps.C. § 603(c)]

f. [6:166] **Notice required to nonconsenting shareholders:** Unless the consents of all shareholders entitled to vote were solicited in writing, "prompt notice" of any shareholder action taken by written consent must be given to all such shareholders who did not execute such consents. [Corps.C. § 603(b)(2)]

(1) [6:166.1] **What constitutes "prompt notice":** The statute does not specify how soon notice must be given to qualify as "prompt." Delaware has a similar provision in its statute permitting stockholder consents (Del.Gen.Corp.L. § 228(e)), and the Delaware Chancery Court ruled that "prompt" for this purpose should be determined by reference to the notice required of stockholder appraisal rights following completion of a merger or consolidation—i.e., 10 days, per Del.Gen.Corp.L. § 262(d). [*Mehta v. Mobile Posse, Inc.* (Del.Ch. 2019) 2019 WL 2025231, *10 (unpub.)]

By analogy, prompt notice of shareholder action under Corps.C. § 603 would likewise be sent within 10 days after written consent is secured from shareholders. [See Corps.C. § 1301(a) (corporation to mail shareholders notice of approval of reorg within 10 days after date of approval)]

(2) [6:167] **Matters requiring notice *before action taken:*** Moreover, where the action taken is the approval of the following transactions, such notice must be given to all unsolicited and nonconsenting shareholders at least *10 days* before the consummation of the transaction involved (in order to give them opportunity to take steps to challenge the action). [Corps.C. § 603(b)(1)]

The transactions requiring such special notice are:

- Approval of contracts in which a director has a financial interest (Corps.C. § 310, ¶ *6:286*);

- Indemnification of corporate agents, officers or directors (Corps.C. § 317, ¶ *6:445*);

- Corporate reorganizations (Corps.C. § 1201, ¶ *8:264*) or conversions (Corps.C. § 1152, ¶ *8:471*), other than reorganizations or conversions in which dissenters' rights apply; and

- Liquidation distributions inconsistent with preferred stock preference (Corps.C. § 2007, ¶ 8:947). [Corps.C. § 603(b)(1)]

[6:168] ***Reserved.***

6. [6:169] **Compare—Controlling Shareholder Action; Fiduciary Limitations:** The law recognizes that shareholders having voting control have the power, directly or indirectly, to make the corporation act as they choose. However, that power cannot be exercised solely for their own benefit. Rather, in certain circumstances, controlling shareholders are subject to a *fiduciary duty* to the other (minority) shareholders. (*See "Conflict of Interest Limitations," ¶ 6:285 ff.*)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 6-C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

C. Director Meetings and Actions

1. [6:173] Matters Requiring Action by Directors
    a. [6:174] Application
    b. [6:175] Compare—close corporations
    c. [6:176] Delegation of authority by directors
        (1) [6:177] Delegation of authority to officers
        (2) [6:179] Delegation of authority to nondirectors
            (a) [6:180] Limitation
        (3) [6:181] Delegation of authority to directors' committee
            (a) [6:182] Application
            (b) [6:184] Limitations on powers delegated
            (c) [6:185] Procedure for appointment
            (d) [6:186] Functioning of committees
    d. [6:187] Prior authorization vs. subsequent ratification
        (1) [6:187.1] Comment
        (2) [6:187.2] Comment
    e. [6:187.6] Special “emergency” powers
        (1) [6:187.7] “Emergency” defined
        (2) [6:187.8] Limitation—no board action where shareholder approval required
2. [6:188] Directors' Meetings
    a. When meetings held
        (1) [6:189] Regular meetings
        (2) [6:190] Special meetings
            (a) [6:191] Compare—annual meetings
    b. [6:193] Who may call meetings
        (1) [6:194] Form of call
    c. Notice of meeting
        (1) [6:197] Regular meetings
        (2) [6:198] Special meetings
            (a) [6:199] Form of notice
                1) [6:199.2] Notice during “emergency”
            (b) Amount of notice
            (c) [6:202] Need not state purpose of meeting
            (d) Waiver of notice

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

                1) [6:203] Written waivers
                2) [6:204] Failure to object as waiver
        (3) [6:205] Adjourned meetings
            (a) [6:206] Comment
    d. [6:207] Place of meetings
        (1) [6:208] Wherever quorum present
            (a) [6:209] Example
        (2) [6:210] Board meeting by telephone or electronic conference
            (a) [6:210a] Telephonic or video meetings
            (b) [6:210b] Electronic meetings
    e. [6:211] Quorum requirements
        (1) [6:212] Permissible variations in articles or bylaws
        (2) [6:213] Director's financial interest as affecting quorum requirements
            (a) [6:214] Exception—indemnification for litigation costs
        (3) [6:214.1] Officer deemed director during “emergency”
        (4) [6:215] Board action where no quorum
            (a) Exceptions
                1) [6:215.1] Adjournments
                2) [6:215.2] Filling board vacancies
            (b) [6:216] Comment
    f. [6:218] Effect of outsiders being present
    g. [6:219] Vote required at meeting
        (1) [6:220] Example
        (2) [6:221] Permissible variations in articles or bylaws
            (a) [6:221.1] Supermajority quorum or vote requirements not applicable to dissolution
        (3) [6:222] Director's financial interest as affecting vote required
            (a) [6:223] Approval by majority of other directors
                1) [6:223.1] Example
            (b) [6:223.2] Effect of interested director voting on transaction
                1) [6:223.3] Burden of proof re “fairness” shifts
            (c) [6:224] Compare—director's indemnification as affecting required vote
        (4) [6:225] Loss of quorum as affecting vote required
            (a) [6:226] Example
            (b) [6:227] Bylaws may vary
    h. [6:228] Procedure at meeting
        (1) [6:229] Chair
        (2) [6:230] Agenda
        (3) [6:231] Adjournment
        (4) [6:232] Recording minutes
    i. [6:232.1] Deadlock on board; provisional directors
        (1) [6:232.2] Appointment of provisional director in close corporation
3. [6:233] Action by Written Consent
    a. [6:233.1] Written consent to fill board vacancies
    b. [6:233.2] Written consent to “interested director” transaction
    c. [6:233.3] Written consent to “common director” transaction
4. [6:234] Removal of Directors
    a. [6:235] By shareholder action
        (1) [6:236] Limitation to protect cumulative voting
        (2) [6:236.1] Limitation to protect class voting

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b. [6:237] *Not* by director action
(1) [6:238] Exception—felons, incompetents
c. [6:239] By court action
(1) [6:242] Nonstatutory grounds
d. [6:242.1] Potential consequences for refusing to acquiesce to removal
5. [6:243] Directors' Duties and Liabilities
a. [6:244] Fiduciary duty of care
(1) [6:244.1] Relationship of Corps.C. § 309 to common law
(2) [6:245] "Business judgment rule"
(a) [6:245.1] Good faith presumed
(b) [6:245.2] Rationale
(c) [6:245.3] "Disinterested and independent"
1) Application
2) [6:245.4] Comment
(d) [6:245.5] No liability for "ordinary negligence"
(e) [6:246] Directors must use reasonable care in ascertaining facts
1) [6:246.1] Compare—Delaware law
(3) [6:247] Liability for failure of oversight
(4) [6:247.1] Corporate takeovers
(a) [6:247.2] "Friendly" takeovers
1) [6:247.2a] Burden on plaintiff to rebut presumption of validity
(b) [6:247.3] Hostile takeovers
1) [6:247.4] Presumption of validity inapplicable
a) [6:247.5] California adopts two-prong Delaware test
b) [6:247.5a] Shareholder approval alternative
2) [6:247.5b] Compare—suits to recover loss of share value
3) [6:247.6] Examples of defensive tactics accorded business judgment rule protection
a) [6:247.7] Self-tender offer excluding raider ("lollipop")
1/ [6:247.8] SEC limitations
b) [6:247.9] "Poison pill" plans
1/ [6:247.9a] Limitation
c) [6:247.10] Self-tender offers
d) [6:247.11] "Golden parachutes"
e) [6:247.11a] Combination of tactics
4) [6:247.12] Compare—defensive tactics *not* protected by business judgment rule
a) [6:247.13] "Greenmail" payments
b) [6:247.14] "Scorched earth" provisions
c) [6:247.15] Retrospective defensive measures
d) [6:247.16] Sales to others at lower price
e) [6:247.17] Lock-up options
f) [6:247.17a] Board action to obstruct shareholder voting
5) [6:247.18] Compare—"porcupine" provisions
(5) [6:247.19] Effect of well-functioning special committee and informed shareholder vote
(6) [6:247.20] Effect of informed, voluntary vote of disinterested stockholders
(7) [6:248] Reliance on reports from others
(a) [6:248.1] What constitutes a "report"
(8) [6:248.5] Reliance on expert opinion
(9) [6:249] Limited duty to creditors when corporation insolvent
(a) [6:249.1] No fiduciary duty to creditors when corporation in "vicinity" of insolvency

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) [6:249.2] Applicability of "business judgment" rule
(c) [6:249.3] Bondholders treated as creditors
(10) [6:250] Claim arising from *prebankruptcy* conduct *not* preempted by bankruptcy law
(11) [6:250e] Statute of limitations on action for breach of duty of care?
(12) [6:250.1] Limiting director liability for breaches of due care
(a) Limitations
1) [6:250.4] No insulation from direct shareholder actions
2) [6:250.5] No insulation against equitable relief
3) [6:250.6] No insulation from liability for highly culpable misconduct ("seven deadly sins")
a) [6:250.6a] Compare—SPC directors
b) [6:250.7] Comment
4) [6:250.8] Inapplicable to officers
5) [6:250.9] Not retroactive
(13) [6:250.15] Special statutory provisions applicable to SPC directors
(14) [6:250.16] Special statutory provisions applicable to benefit corporation directors
(15) [6:251] Compare—federal securities laws
(16) [6:251.1] Compare—liability for negligence or intentional torts
(a) [6:251.2] Rationale
(b) [6:251.3] Requirements for third party tort action against director
(c) Examples
(d) [6:251.5] Exception for volunteer directors of specified *nonprofit* corporations
b. [6:252] Fiduciary duty of loyalty
(1) [6:252.1] Not affected by articles
(2) [6:252.2] Applicable to corporate general partners of limited partnership
(3) [6:252.3] Jury trial right in breach of fiduciary duty action
(4) [6:252.4] Compare—no duty of loyalty to warrant holders
c. [6:253] Statutory liabilities
(1) [6:253.1] False reports or accounting entries
(2) [6:254] Unlawful dividends
(3) [6:255] Improper liquidation distributions
(4) [6:256] Unauthorized loans or guarantees
(5) [6:256.5] ERISA malfeasance
(6) [6:257] Criminal liabilities

[6:170] Action by directors is normally taken by resolutions adopted at meetings by the board, or by committees of directors to which the board's authority has been delegated (¶ 6:176 ff.). Alternatively, board action may be taken without any meeting by unanimous written consent of the directors (¶ *6:233*).

The procedures to be followed for action by directors are set forth in the Corporations Code, as discussed in this chapter. But most of the statutory standards can be modified in the articles or bylaws (*see* ¶ *4:296*); or, in the case of statutory close corporations, in the shareholders' written agreement (*see* ¶ *3:248*).

Cross-refer: Qualifications of directors (¶ *4:278*); shareholder election of directors (¶ *6:13*); filling vacancies on board (¶ *6:18*); director duties and compensation (¶ *6:391*).

[6:171 - 6:172] ***Reserved.***

1. [6:173] **Matters Requiring Action by Directors:** Unless it chooses to delegate some of its authority (¶ 6:176 ff.), all powers of management and control of a corporation are vested in its board of directors. "Subject to the provisions of this division and

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

any limitations in the articles … the business and affairs of the corporation shall be managed and *all corporate powers shall be exercised* by or under the direction of the board …" [Corps.C. § 300(a) (emphasis added)]

Thus, *all* matters involving the "business and affairs" of the corporation are subject to ultimate direction by its board of directors. And, whenever corporate action is required, it means action by, or under the authority of, the board (subject to shareholder approval, where required; *see* ¶ *6:12 ff.*).

a. [6:174] **Application:** Usually, the board of directors delegates to the corporate officers authority to conduct the corporation's day-to-day operations *in the ordinary course of its business* (¶ 6:177). However, specific board action will be required for any action *not* in the ordinary course of business—i.e., everything from adoption of business policies, to authorizing significant corporate transactions (e.g., acquisitions, financings, etc.), to approval of changes in the corporate structure. This includes such matters as:

• Election or removal of officers (Corps.C. § 312, ¶ *6:266*);

• Adoption or amendment of bylaws (Corps.C. § 211, ¶ *4:177*);

• Authorizing sale and issuance of securities (Corps.C. § 409, ¶ *5:6*);

• Corporate borrowing and loans (see Corps.C. § 207(g); and special requirements where loans or guarantees benefit insiders, Corps.C. §§ 310, 315-316, 1501(b); ¶ *6:471*);

• All transactions between the corporation and any of its officers, directors or shareholders (*see* ¶ *6:285 ff.*);

• Establishing corporate bank accounts and depositories, and authorizing signatories on such accounts (¶ *4:443*);

• Employee compensation, including pension, profit-sharing and other employee-benefit plans and employment agreements (Corps.C. §§ 207(f), 300, 315(b), 408; *see* ¶ *6:391 ff.*);

• Acquisition (by purchase or lease) of major items of equipment or property (other than as inventory);

• Removing directors of unsound mind or convicted of felony (Corps.C. § 302, ¶ *6:238*);

• Filling vacancies on the board (Corps.C. § 305(a), ¶ *6:18*);

• Indemnification (Corps.C. § 317(e), ¶ *6:445*; see also Corps.C. § 2702 (SPCs, ¶ *9:136 ff.*));

• Calling shareholders' meetings (Corps.C. § 600, ¶ *6:58*);

• Declaration of dividends, redemption or repurchase of shares (Corps.C. §§ 166, 500(a); *see* ¶ *7:76*);

• Amendment of articles (Corps.C. §§ 901-902, 2302, 2304; *see* ¶ *8:49*);

• Disposition of corporate assets (Corps.C. § 1001(a); *see* ¶ *8:584*);

• Mergers, reorganizations and making share exchange tender offers (Corps.C. §§ 1101, 1200; *see* ¶ *8:236*).

b. [6:175] **Compare—close corporations:** Action by the board of directors may not be necessary in a statutory close corporation. The shareholders of such a corporation, by written agreement, may confer upon themselves (or corporate officers) complete power over management and control of the corporation. In such cases, action by the shareholders (or officers) constitutes valid action by the corporation. [Corps.C. § 300(b), ¶ *3:248*]

c. [6:176] **Delegation of authority by directors:** Unless prohibited by the articles or bylaws, the directors may delegate to others many (but not all) of their powers above (¶ 6:173 ff.)—i.e., it is sufficient that the business or affairs of the corporation be managed by "or under the direction of" the board of directors. [Corps.C. § 300(a); see *Biren v. Equality Emergency Med. Group, Inc.* (2002) 102 CA4th 125, 137, 125 CR2d 325, 332 (citing text)]

As to matters upon which the board has properly delegated its authority, board action is no longer necessary. But, of course, the board can always revoke the delegation of authority and exercise its powers directly.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [6:177] **Delegation of authority to officers:** Management powers are commonly delegated by the board of directors to the corporate officers, in the bylaws or by formal resolution. The authority so conferred makes such officers *agents* of the corporation in dealings with third persons, so that further action by the board is no longer necessary to bind the corporation. [Corps.C. § 312, ¶ *6:268*]

➪ [6:178] ***PRACTICE POINTER:*** If you represent third parties dealing with the corporation, you will be expected to advise them whether to accept signatures by officers alone, or to insist on approval by the board of directors.

It is sometimes difficult to tell from the bylaws or a board resolution whether a corporate officer has sufficient authority to take major actions on behalf of the corporation (e.g., to sign a long term lease, to sell sizeable corporate assets, etc.). Therefore, unless it is *crystal clear* that the corporate officers can act without formal board approval, it is best to insist on a duly-adopted resolution by the board of directors authorizing or approving the particular transaction.

(Of course, even *unauthorized* dealings by a corporate officer may be held binding on the corporation if the officer had "apparent authority"; *see* ¶ *6:271*. But this may be difficult to prove, and could expose your client to the costs and risks of litigation.)

(2) [6:179] **Delegation of authority to nondirectors:** The board of directors may properly delegate the day-to-day management of the corporation's business to employees or others, including an outside management company … "*provided* that the business and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board." [Corps.C. § 300(a) (emphasis added)]

(a) [6:180] **Limitation:** This provision pertains only to delegating management of the corporation's *business operations*. It would *not* permit delegation of the board's ultimate statutory functions or powers to govern—e.g., to declare dividends, to adopt or amend bylaws, etc. [See *Kennerson v. Burbank Amusement Co.* (1953) 120 CA2d 157, 173-174, 260 P2d 823, 832-833]

(3) [6:181] **Delegation of authority to directors' committee:** Broader delegations of authority are allowed to committees of directors appointed by the full board. Except as to specifically enumerated matters (¶ 6:184), such committees may exercise whatever authority is conferred upon them by the board or provided in the bylaws. [Corps.C. § 311]

(a) [6:182] Application:

- XYZ Corp's bylaws state that the "executive committee" shall exercise the powers of the full board in the interim between board meetings. This general delegation of power gives the executive committee power to *hire and fire corporate officers*—with or without cause—just as the full board could do (*see* ¶ *6:266*). [*American Ctr. for Ed., Inc. v. Cavnar* (1978) 80 CA3d 476, 493, 145 CR 736, 747 (superseded by statute on other grounds as stated in *Patton v. Sherwood* (2007) 152 CA4th 339, 346-347, 61 CR3d 289, 294-295)—executive committee can remove president from office]

Further, unless the articles, bylaws or board resolution provides otherwise, the "executive committee" has the same power as the full board to *remove committee members* (i.e., the majority of the directors' committee can throw off of the committee any of its fellow members—with or without cause). [*American Ctr. for Ed., Inc. v. Cavnar*, supra, 80 CA3d at 494, 145 CR at 747]

[6:183] ***Reserved.***

(b) [6:184] **Limitations on powers delegated:** The only powers of the full board that may *not* be delegated to a directors' committee are:

- Approval of any action that also requires shareholder approval (e.g., amendment of articles of incorporation); [Corps.C. § 311(a)]

- Filling vacancies on the board or on any committee of directors (but compare *removal* from a directors' committee, ¶ 6:182); [Corps.C. § 311(b)]

- Fixing compensation of directors for service on the board or any directors' committee; [Corps.C. § 311(c)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Adoption, amendment or repeal of bylaws; [Corps.C. § 311(d)]

• Amending or repealing any resolution of the full board that by its *express* terms is not amendable or repealable; [Corps.C. § 311(e)]

• Authorizing dividends or other distributions to the shareholders (but a directors' committee may fix the rate or amount of distribution within a price range previously determined by the full board); [Corps.C. § 311(f)]

• Appointing other committees of directors or members thereof. [Corps.C. § 311(g)]

(c) [6:185] **Procedure for appointment:** Committees may be appointed by a resolution approved by a majority of the authorized number of directors. Each committee must consist of 2 or more directors (plus any alternates appointed to act in their absence at committee meetings). All appointments are at the pleasure of the board, and the committees can be dissolved at any time. [Corps.C. § 311]

• ***FORM:*** Resolution Appointing Directors' Committee, *see Form 6:J.*

(d) [6:186] **Functioning of committees:** All of the statutory provisions discussed below as to meetings of the full board (notice, quorum, voting and other requirements) apply also to board committees. [Corps.C. § 307(c)]

d. [6:187] **Prior authorization vs. subsequent ratification:** Normally, any action that could be authorized in advance by the board can be ratified by it subsequently.

However, there may be exceptions: For example, a statute of limitations may require filing of a governmental claim, or filing of suit, by a certain date. Such statutes have been interpreted as requiring filing of a claim that has been duly authorized by the corporation *before* expiration of the time limit. Thus, filing of an *unauthorized* claim would not toll the statute, nor would a subsequent ratification by the board prevent dismissal of the action. [*Dominguez v. Sup.Ct. (Pacific Coast Bank)* (1983) 139 CA3d 692, 695, 189 CR 5, 7]

(1) [6:187.1] **Comment:** Boards of directors frequently ratify actions previously taken by corporate officers, and ratification generally relates back to the date the action was taken by the officers. The holding in *Dominguez*, supra, should be limited to the principle that the ratification of prior acts cannot relate back to destroy rights of third persons *that arose between the time of the officers' act and the directors' subsequent ratification of those acts* (as where, in *Dominguez*, the third person properly obtained *dismissal* of a corporate claim that was unauthorized at the time it was filed). [See Civ.C. § 2313; *Allied Mutual Ins. Co. v. Webb* (2001) 91 CA4th 1190, 1195-1196, 111 CR2d 426, 430 (recognizing common law limitation on ratification that it "cannot date back to destroy intervening rights of third persons or otherwise to achieve an inequitable result")]

(2) [6:187.2] **Comment:** A corporation may ratify otherwise lawful actions that were taken without complying with the General Corporations Law or the corporation's articles or bylaws. The ratification process requires approval by the current board and may require shareholder approval as well. [See Corps.C. § 119; for a detailed discussion of this process, *see* ¶ 6:597.20 ff.]

[6:187.3 - 6:187.5] ***Reserved.***

e. [6:187.6] **Special "emergency" powers:** The Code expressly confers upon the corporation the power, during *or in anticipation of* an "emergency" (¶ 6:187.7), to (1) modify lines of succession to accommodate the incapacity of any director, officer, employee or agent resulting from the "emergency," and (2) relocate the principal office, designate alternative principal or regional offices, or authorize the officers to do so. ("Emergency" bylaws, however, may alter these statutory provisions; *see ¶ 4:397 ff.*) [Corps.C. § 207(i)(1)]

(1) [6:187.7] **"Emergency" defined:** An emergency is an event or circumstance listed below that prevents a quorum of a corporation's board from convening:

• a natural catastrophe, including (but not limited to) a hurricane, tornado, storm, high water, wind-driven water, tidal wave, tsunami, earthquake, volcanic eruption, landslide, mudslide, snowstorm, drought, epidemic, pandemic, or disease outbreak;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- any fire, flood, or explosion, regardless of cause;
- an attack "by an enemy" of the state or the United States, or a warning from the federal government that an enemy attack is probable or imminent;
- a terrorist attack or other manmade disaster that results in extraordinary levels of casualties or damage or disruption severely affecting the infrastructure, environment, economy, government functions, or population (including mass evacuations);
- a state of emergency proclaimed by the Governor or the U.S. President. [Corps.C. § 207(i)(5)]

(2) [6:187.8] **Limitation—no board action where shareholder approval required:** During or in anticipation of an "emergency" (¶ 6:187.7), the board may take necessary and appropriate action to respond to the emergency, mitigate its effects, or comply with lawful federal and state government orders. However, the board may not take any action that requires a shareholder vote, unless the required vote of the shareholders was obtained before the emergency. [Corps.C. § 207(i)(3)]

2. [6:188] **Directors' Meetings:** The following are the statutory standards governing meetings of the board of directors.

But note: Except as to certain of the quorum and voting requirements (¶ 6:212, 6:221), any of these standards may be modified in the corporation's articles or bylaws. Thus, the rules below (¶ 6:189 ff.) as to time and place of meetings, notice requirements, etc., apply only if the corporation has *not* adopted different provisions in its articles or bylaws (*see ¶ 4:296 ff.*).

a. When meetings held

(1) [6:189] **Regular meetings:** Regular board meetings may be required in the corporation's bylaws, or by prior resolutions adopted by the board itself. (Regular board meetings are more common in larger corporations, particularly those with outside directors.)

Where regular meetings are required, no formal call or notice is necessary. Regular meetings are held at the time and place fixed in the bylaws or prior board resolution requiring such meetings. [Corps.C. § 307(a)(2)]

(2) [6:190] **Special meetings:** Otherwise, directors' meetings are held *only when called;* and (unless notice is waived) only after notice to each of the directors (*see ¶ 6:197 ff.*). [Corps.C. § 307(a)(1)]

(a) [6:191] **Compare—annual meetings:** Although *shareholders* are required to meet annually for the election of directors (*see ¶ 6:13*), there is *no statutory requirement* for an annual meeting of directors.

Even so, it is customary for the board to meet, immediately following the annual shareholders' meeting, to elect officers for the forthcoming year, appoint board committee members, etc. Or, if the entire board of directors and all shareholders are the same persons (or nearly so), it may be more convenient to hold a *joint* annual shareholder/board meeting (*see ¶ 6:48.1*).

➪ [6:192] ***PRACTICE POINTERS:*** In practice, the number and frequency of meetings depends on the nature of the corporation's business, and the extent of the board's involvement in day-to-day management.

An organizational meeting of the board should be held as soon as practical following incorporation (*see ¶ 4:405*). Thereafter, however, it is normally up to the members of the board to decide how frequently to meet.

b. [6:193] **Who may call meetings:** Special meetings of the board may be called either by:

- The chairperson of the board;
- The president, or any vice-president, or the secretary;
- *Any two directors* (regardless of the size of the board); or
- Any other persons authorized by the articles or bylaws. [Corps.C. § 307(a)(1)]

(1) [6:194] **Form of call:** The Code does not specifically require a written call, or that the purpose of the meeting be stated (but the bylaws may provide otherwise). [See Corps.C. § 307(a)(2)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

➪ [6:195] ***PRACTICE POINTER:*** Even if a written call is not required, good practice dictates a writing wherever possible, so that the call can be filed in the minutes book along with the notice and minutes of the meeting.

Moreover, the persons calling the meeting often will be doing so by written notice so that the same document that constitutes the call serves as the meeting notice (¶ 6:197 ff.).

[6:196] ***Reserved.***

c. Notice of meeting

(1) [6:197] **Regular meetings:** As stated above (¶ 6:189), *no* notice need be given for regular board meetings, as long as the time and place for such meetings have been fixed in the bylaws or by prior board action. [Corps.C. § 307(a)(2)]

(2) [6:198] **Special meetings:** However, special meetings of the board of directors can be held only after notice to each of the directors. This notice requirement cannot be eliminated in the articles or bylaws (but the directors can *waive* notice, *see ¶ 6:203*). [Corps.C. § 307(a)(2)]

(a) [6:199] **Form of notice:** Directors' meetings can be held on either *written or oral* notice. Indeed, the Code expressly authorizes notice in person or by electronic transmission *or telephone* (including a voice messaging system). [Corps.C. § 307(a)(2)]

(Compare: A *shareholders'* meeting notice must be in writing; *see ¶ 6:68*.)

➪ [6:199.1] ***PRACTICE POINTER:*** Good practice dictates sending out written notice if you expect any problems obtaining waivers of notice from each of the directors (for whatever reason). Although oral notice is just as effective, this avoids any question later on as to whether notice was in fact timely given.

1) [6:199.2] **Notice during "emergency":** If a public "emergency" (¶ 6:187.7) prevents notice from being given in the manner set forth in Corps.C. § 307 or the bylaws, the corporation may give notice in any practicable manner, such as by publication or radio, *unless* "emergency" bylaws (¶ 4:397 ff.) provide otherwise. Any such notice given in "good faith" during an "emergency" binds the corporation and may not be used to impose liability on a corporate director, officer, employee or agent. [Corps.C. § 207(i)(2)(A), (4)]

(b) Amount of notice

- [6:200] If *mailed*, the notice must be given at least *four days* before the meeting. [Corps.C. § 307(a)(2)]
- [6:201] If delivered *personally* or by *electronic* means (including telephone, facsimile, electronic mail and voice mail), *48 hours'* notice is sufficient. [Corps.C. § 307(a)(2)]

Oral notice *in person* or *by telephone* is satisfied even if given to someone other than the director, so long as given at the director's *office* to a person whom the person giving the notice has reason to believe will *promptly communicate it* to the director. [Corps.C. § 118]

(Compare: A *shareholders'* meeting notice must be given at least 10 days before the meeting; *see ¶ 6:82*.)

(c) [6:202] **Need not state purpose of meeting:** The notice of a special board meeting need *not* specify the purpose of the meeting. (And, the same is true for any waiver of notice; *see ¶ 6:203*.) [Corps.C. § 307(a)(2)]

(Compare: A special *shareholders'* meeting notice must set forth the matters to be transacted at the meeting; *see ¶ 6:74*.)

FORM: Notice of Special Board Meeting, *see Form 6:K*.

(d) Waiver of notice

1) [6:203] **Written waivers:** Directors may provide a written waiver of notice, either before or after the meeting. A written consent to the holding of the meeting, or an approval of the minutes, has the same effect as a waiver. The written waiver, consent or approval must be filed with the corporate records or made part of the minutes of the meeting. [Corps.C. § 307(a)(3)]

- ***FORM:*** Waiver of Notice of Board Meeting, *see Form 6:L*.

2) [6:204] **Failure to object as waiver:** In addition, any director who *attends* the meeting and fails to protest the lack of notice before or at the beginning of the meeting, is deemed to have waived notice. [Corps.C. § 307(a)(3)]

(3) [6:205] **Adjourned meetings:** If a meeting is adjourned for more than 24 hours, notice must be given to any directors not present at the time of the adjournment. Such notice must be given "prior to the time of the adjourned meeting." [Corps.C. § 307(a)(4)]

(a) [6:206] **Comment:** No particular amount of notice is required. However, because of the short interval normally involved, such notice usually is given by telephone or electronic means.

d. [6:207] **Place of meetings:** Board meetings may be held wherever stated in the notice of meeting, inside or outside California. If the meeting place is not stated in the notice, or there is no notice, board meetings are to be held wherever designated in the bylaws or prior resolution of the board. [Corps.C. § 307(a)(5)]

(1) [6:208] **Wherever quorum present:** Unless the articles or bylaws provide otherwise, a board meeting may take place wherever a quorum has assembled, as long as notice has been given. And, where it has become *customary* for the board to convene *without* notice, the board may act whenever and wherever a quorum is present. "Valid corporate meetings have been held on a street corner … in a hallway … and in a laboratory …" [*American Ctr. for Ed., Inc. v. Cavnar* (1978) 80 CA3d 476, 491, 145 CR 736, 746 (superseded by statute on other grounds as stated in *Patton v. Sherwood* (2007) 152 CA4th 339, 346-347, 61 CR3d 289, 294-295)]

(a) [6:209] **Example:** Director A refused to attend a board meeting at the corporation's offices, and thereby frustrated efforts of the other two directors, B and C, to assemble the required 3-director quorum. Directors B and C then went to Bank manager to complain about A's acts. Director A saw them there and joined in the conversation in order to justify himself. By so doing, A was held to have *waived* any objection as to notice and quorum, enabling B and C to take effective action (ousting A as president of the corporation). [See *American Ctr. for Ed., Inc. v. Cavnar* (1978) 80 CA3d 476, 491, 145 CR 736, 746 (superseded by statute on other grounds as stated in *Patton v. Sherwood* (2007) 152 CA4th 339, 346-347, 61 CR3d 289, 294-295)]

(2) [6:210] **Board meeting by telephone or electronic conference:** Unless the articles or bylaws provide otherwise, directors need not convene and be physically present together in the same room at a meeting. A board meeting may be held by conference telephone, electronic video screen communication or other electronic transmission by and to the corporation. [Corps.C. § 307(a)(6)]

(a) [6:210a] **Telephonic or video meetings:** Participation in a meeting through conference telephone or video screen communication constitutes "presence in person" as long as all directors can hear each other. [Corps.C. § 307(a)(6)]

(b) [6:210b] **Electronic meetings:** Participation in a meeting through use of electronic transmission by and to the corporation (¶ *4:199.8 ff.*) constitutes "presence in person" provided *both* of the following conditions are satisfied:

• Each director participating in the meeting can communicate with all of the others *concurrently*; and

• Each director is given the *means to participate* in all matters before the board (e.g., a computer, modem and communications software), including the capacity to propose or object to a specific action to be taken by the corporation. [Corps.C. § 307(a)(6)]

➪ [6:210.1] ***PRACTICE POINTER:*** Under Corps.C. § 307(a)(6), a techno-adept majority of directors can compel a techno-illiterate or intimidated minority to participate in an electronic board meeting, so long as the minority is "provided [with] the means of participating"—e.g., the necessary equipment. This can be prevented by a bylaw provision requiring *unanimous* written consent to hold a board meeting electronically.

e. [6:211] **Quorum requirements:** A majority of the authorized number of directors constitutes a quorum for a board meeting, except as provided below (¶ 6:212 ff.). [Corps.C. § 307(a)(7)]

(1) [6:212] **Permissible variations in articles or bylaws:** If a greater-than-majority quorum is desired, the articles or bylaws must so provide. [Corps.C. §§ 204(a)(5), 212(b)(4); *see* ¶ *4:314*]

On the other hand, the articles or bylaws may *reduce* the quorum requirement to less than a majority—but in no event to less than *one-third* of the authorized number of directors, *or 2 directors*, whichever is larger (or in sole-shareholder corporations having only one director, just one). [Corps.C. §§ 307(a)(7), 212(b)(4); ¶ *4:315*]

(2) [6:213] **Director's financial interest as affecting quorum requirements:** In most cases, the fact that one or more of the directors has a personal or financial interest in the matters coming before the meeting does *not* affect quorum requirements —i.e., the "interested" director can be counted in determining the presence of a quorum, even if they are disqualified from voting on the matter in question. [Corps.C. § 310(c); ¶ *6:304*]

(a) [6:214] **Exception—indemnification for litigation costs:** But a different rule applies where the meeting deals with indemnifying directors for litigation costs and liabilities. Directors who are parties to the litigation *cannot* be counted as part of the quorum at such meeting. I.e., such indemnification must be approved by "[a] majority vote of a quorum consisting of directors who are not parties to such proceeding." [Corps.C. § 317(e)(1), ¶ *6:461*; *but see* ¶ *9:136 ff.* re SPCs]

(3) [6:214.1] **Officer deemed director during "emergency":** During a public "emergency" (¶ 6:187.7), the corporation may deem one or more corporate officers who are present at the meeting to be a director as may be necessary to achieve a quorum*, unless* "emergency" bylaws (¶ 4:397 ff.) provide otherwise. The designation of an officer as an "emergency" director is made in order of *rank*, and within the same rank, in order of *seniority*. (Although the Code does not expressly so state, presumably such "emergency" directors may also vote at the meeting.) Any such designation made in "good faith" during an "emergency" binds the corporation and may not be used to impose liability on a corporate director, officer, employee or agent. [Corps.C. § 207(i)(2)(B), (4)]

(4) [6:215] **Board action where no quorum:** In general, no board action can be taken in the absence of a quorum. [Corps.C. § 307(a)(8)]

(a) Exceptions

1) [6:215.1] **Adjournments:** A majority of the directors present at the meeting, though less than a quorum, may adjourn the meeting to another place and time. [Corps.C. § 307(a)(4); ¶ *6:231*]

2) [6:215.2] **Filling board vacancies:** And, a majority of the directors in office, though less than a quorum, may fill a board vacancy created by death, incapacity, resignation or increase in the authorized number of directors. However, they must do so at a duly-noticed meeting (unless notice is waived, ¶ *6:203*); otherwise their *unanimous written consent* is required (*see* ¶ *6:233 ff.*). (Directors may also fill a vacancy created by a director's removal from office, even where the number of remaining directors is less than a quorum, but only if authorized by the articles or a bylaw adopted by the shareholders.) [Corps.C. § 305(a)]

(b) [6:216] **Comment:** Because of the strictures of the quorum requirement, dissident directors may—at least temporarily—effectively block corporate action by deliberately staying away from board meetings. Dictum in one case decided under prior state law suggests that the purpose of quorum requirements is to ensure the minority's right of consultation—not to allow it to frustrate the will of the majority shareholders and directors. [*American Ctr. for Ed., Inc. v. Cavnar* (1978) 80 CA3d 476, 497, 145 CR 736, 749, fn. 10 (superseded by statute on other grounds as stated in *Patton v. Sherwood* (2007) 152 CA4th 339, 346-347, 61 CR3d 289, 294-295)]

However, ultimately, in such a case, the remedy would be for the shareholders to remove the recalcitrant directors or elect a new board capable of functioning. (Another possibility might be the appointment of a provisional director where there is an even number of directors; *see* ¶ *6:232.1, 8:845*.)

[6:217] ***Reserved.***

f. [6:218] **Effect of outsiders being present:** It is up to the board as a whole to decide whether persons other than directors may be present during the meeting. If a majority of the directors invites an outsider to attend, the other directors cannot exclude them or refuse to participate in the meeting on this ground. [*Burt v. Irvine Co.* (1964) 224 CA2d 50, 51, 36 CR 270, 271 (interpreting West Virginia law); see *American Ctr. for Ed., Inc. v. Cavnar* (1978) 80 CA3d 476, 492, 145 CR 736, 746 (superseded by statute on other grounds as stated in *Patton v. Sherwood* (2007) 152 CA4th 339, 346-347, 61 CR3d 289, 294-295)]

g. [6:219] **Vote required at meeting:** As long as a quorum is present, board action may generally be taken by affirmative vote of a majority of the directors *present* at the meeting (subject to limitations noted below; ¶ 6:221 ff.). [Corps.C. § 307(a)(8)]

(1) [6:220] **Example:** If 13 directors are authorized, a quorum of seven is required for a board meeting (¶ *6:211*). If only seven directors are present, action can be taken by four of them (a majority of the quorum present)—even though they are less than a third of the majority of the authorized number of directors.

(2) [6:221] **Permissible variations in articles or bylaws:** The *articles* (not the bylaws) may require a supermajority vote of the directors on any or all corporate actions; even a unanimous vote may be required. [Corps.C. § 204(a)(5), ¶ *4:83*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

But neither the bylaws nor the articles may permit board action by *less* than a majority of the directors attending the meeting at which a quorum is present. [Corps.C. § 307(a)(8)]

(a) [6:221.1] **Supermajority quorum or vote requirements not applicable to dissolution:** A corporation may elect to wind up and dissolve by resolution adopted by a simple majority of the board and without shareholder approval under certain circumstances (i.e., no shares issued; or corporation in bankruptcy; or it has disposed of its assets and been inactive for more than five years). [Corps.C. § 1900(b); *see ¶ 8:753*]

The articles or bylaws may not require more than a majority vote to authorize dissolution. [Corps.C. § 204(a)(5)]

(3) [6:222] **Director's financial interest as affecting vote required:** If the matter voted upon is one in which any director has a direct or indirect financial interest, they should *fully disclose* such interest and *abstain* from voting.

The interested director's presence at the meeting may be counted toward establishing a *quorum* of directors. [Corps.C. § 310(c)]

Indeed, if necessary for approval, the interested director may vote (or sign a unanimous written consent, *¶ 6:296.2a*) on the matter in which they are financially interested (the consequences of doing so are discussed below; ¶ 6:223.2). [Corps.C. § 310(a)(3)]

(a) [6:223] **Approval by majority of other directors:** If a majority of the directors present are disinterested and approve or ratify the transaction, it is "neither void nor voidable" because one or more other directors have a financial interest, *provided*:

- *All material facts* as to the transaction, and the director's interest therein, have been *disclosed* to or are otherwise *known* by the board; *and*

- The contract or transaction is "*just and reasonable*" as to the corporation at the time it was approved or ratified. [Corps.C. § 310(a)(2)]

1) [6:223.1] **Example:** If a director is also an employee of the corporation, their salary may be set by resolution of the board. That director's presence can be counted for quorum purposes (¶ 6:211), and does not affect the validity of board action taken on the resolution. But such director should abstain from voting on the resolution; and the resolution should be approved by a sufficient vote of other disinterested directors present.

Thus, if the board consists of five directors, the interested director may be counted to obtain the requisite quorum of three. But such director should disclose their interest and abstain on the vote. A majority of the other disinterested directors present must approve the transaction (e.g., two out of three, or three out of four or five).

(b) [6:223.2] **Effect of interested director voting on transaction:** The director's vote on a contract or transaction in which they have a financial interest does *not* invalidate the board action. The vote counts, if necessary, for approval of the transaction. [See Corps.C. § 310(a)(3); *Sammis v. Stafford* (1996) 48 CA4th 1935, 1943, 56 CR2d 589, 594 & fn. 7 (quoting text)]

1) [6:223.3] **Burden of proof re "fairness" shifts:** However, in such event, if the transaction is later challenged, it will be set aside unless the interested director (or other person asserting the *validity* of the transaction) can *prove* it was "just and reasonable" to the corporation. [Corps.C. § 310(a)(3); *Sammis v. Stafford* (1996) 48 CA4th 1935, 1943, 56 CR2d 589, 594, fn. 7 (quoting text); *see ¶ 6:297*]

Compare: Where the transaction is approved by a disinterested board, there is, in effect, a presumption of "fairness"; and the burden is on the person challenging the transaction to prove inadequate disclosure or that it was *not* "just and reasonable" (*see ¶ 6:297.1*).

(c) [6:224] **Compare—director's indemnification as affecting required vote:** Where a director seeks indemnification from the corporation for litigation costs or liability, their vote may *not* be counted to authorize the indemnity. Here, a majority vote is required by a quorum of directors who are *not* parties to the litigation (*see ¶ 6:214*). [Corps.C. § 317(e)(1)]

(4) [6:225] **Loss of quorum as affecting vote required:** If a quorum was present at the outset of the meeting, the board may continue to function even though some of the directors withdraw from the meeting, so that the quorum is lost. But, any action thereafter taken requires *approval by a majority of the initial quorum required* for the meeting. [Corps.C. § 307(a)(8)]

(a) [6:226] **Example:** The authorized number of directors of XYZ Corp. is 13, so that a quorum of seven is required for a board meeting. If seven directors attend, and then two of them withdraw, the meeting can continue. But any resolution

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

will still have to be approved by at least four of the remaining five directors (a majority of the original seven-director quorum).

(b) [6:227] **Bylaws may vary:** The bylaws may (and often do) prohibit continuation of the meeting if a quorum is lost (*see ¶ 4:318*).

h. [6:228] **Procedure at meeting:** The degree of formalities at board meetings often depends on the size of the corporation. In small, closely-held corporations, meetings may be informal, with the minutes prepared in advance (with waivers of notice) and simply submitted for approval. But in publicly-held corporations, and particularly where there is any divisiveness among the directors, more formal procedures are followed:

(1) [6:229] **Chair:** The bylaws usually provide who is to preside at board meetings (*see ¶ 4:296*). (Usually, the directors are authorized to elect a chairperson to preside; otherwise, the president serves as chair.) Often, the attorney for the corporation is present at the invitation of the board to assist or answer questions.

(2) [6:230] **Agenda:** The first order of business is to determine that the required quorum of directors is present.

Typically, the next order of business is approval of the minutes of the prior meeting. If the minutes have not been circulated in advance, they are reviewed at the meeting and approved either as is or with appropriate changes.

Then, the meeting may turn to business. Each item of new business is presented, discussed and acted upon by motion, second and vote.

Often, a written agenda is prepared in advance by the chairperson (or the attorney). Such agenda facilitates taking of notes at the meeting, and the secretary's preparation of minutes following the meeting.

(3) [6:231] **Adjournment:** The majority of the directors present (whether or not a quorum) may adjourn a board meeting to another time and place, unless the articles or bylaws provide otherwise. [Corps.C. § 307(a)(4)]

If a board meeting is adjourned for more than 24 hours, *notice* must be given to any of the directors not present when the adjournment occurred. [Corps.C. § 307(a)(4), *see ¶ 6:205*]

(4) [6:232] **Recording minutes:** The bylaws usually provide that the secretary shall attend board meetings and prepare the minutes. The minutes are usually signed by the secretary and chairperson, and then filed in the minutes book, together with copies of the notice of meeting or directors' waivers of notice as the official record of the proceedings of the meeting. (In lieu of "hard copy," the minutes may be recorded electronically "or in another form capable of being converted into clearly legible tangible form.") [See Corps.C. § 1500]

(A copy of the minutes, certified by the secretary or assistant secretary, is prima facie evidence the meeting was held and that the resolutions stated therein were duly adopted; see Corps.C. § 314.)

- ***FORM:*** Minutes of Directors' (Annual/Special) Meeting, *see Form 6:M*.

➪ [6:232a] ***PRACTICE POINTERS:*** Plaintiffs (both government and private) increasingly focus on minutes when seeking to establish breach of the duty of care, loyalty or good faith. Counsel should consider recommending the following guidelines regarding the preparation of board and committee minutes:

- Minutes should reflect the process and extent to which directors *informed themselves before taking action* (e.g., noting reports received, board questions, management responses, etc.).

- If counsel acts as recording secretary, notes on *privileged* matters should be *separated* from notes taken as secretary.

- As routine "housekeeping," retain only the *final* minutes approved by the board. Discard earlier—and possibly *erroneous*—drafts that could be misconstrued. (*Caution:* In view of the universal practice of preparing drafts of documents electronically, it should be assumed that a complete trail of drafts is accessible from one or more of the servers of those who participated in the preparation and review of the drafts.)

i. [6:232.1] **Deadlock on board; provisional directors:** Where the board consists of an even number of directors (either because so provided in the articles or bylaws, or because of an unfilled vacancy on the board), and the directors are unable to agree on corporate action, a petition may be filed in the superior court for appointment of a *provisional director* to break the deadlock. Such a petition may be filed by any of the directors or by holders of *one-third* or more of the voting shares. The court may appoint a provisional director on finding the corporate deadlock jeopardizes the continued conduct of the corporate business or its property. [Corps.C. § 308(a); see *In re ANNRHON, Inc.* (1993) 17 CA4th 742, 751-752, 21 CR2d 599, 604]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Such an appointment may be made regardless of whether there is any vacancy on the board, and despite any limiting provision in the corporation's articles or bylaws. [Corps.C. § 308(a)]

(1) [6:232.2] **Appointment of provisional director in close corporation:** A provisional director may also be appointed to the board of a *statutory close corporation* (*¶ 3:233 ff.*) where the shareholders agreement does not transfer all board powers to the shareholders.

Thus, where the agreement delegates only "management and administrative decisions and functions," a provisional director could be appointed to break a deadlock over the exercise of corporate powers retained by the directors (e.g., a decision whether to sell or expand the business). [*In re ANNRHON, Inc.* (1993) 17 CA4th 742, 751-752, 21 CR2d 599, 604]

Cross-refer: For qualifications, duties and liability immunity of provisional directors generally, *see ¶ 8:845*.

3. [6:233] **Action by Written Consent:** With certain exceptions (¶ 6:233.1), any action the board (or a committee) could take at a meeting can be taken without a meeting if *all* the directors individually or collectively consent in writing to the action and if the number of then-serving directors constitutes a quorum. The written consent (or consents) must be filed with the minutes of the board's proceedings. [Corps.C. § 307(b), (c)]

No particular form is required, as long as it clearly expresses the directors' consent to the action taken. Facsimiles or other electronic transmissions can be used as "written" consents. [Corps.C. §§ 8, 195]

• ***FORM:*** Directors' Action by Unanimous Written Consent, *see Form 6:N*.

a. [6:233.1] **Written consent to fill board vacancies:** Unless provided otherwise in the articles or bylaws, vacancies on the board arising from *resignation, death or incapacity* of one or more directors, or from an increase in the authorized number of directors, may be filled upon approval of the remaining directors—*even if the remaining directors constitute less than a quorum* and *even if there is only one remaining director*. (Directors may also fill a vacancy created by a director's *removal* from office, even where the number of remaining directors is less than a quorum, but only if authorized by the articles or a bylaw *adopted by the shareholders*.) [Corps.C. § 305(a)]

b. [6:233.2] **Written consent to "interested director" transaction:** *See ¶ 6:297.2 ff.*

c. [6:233.3] **Written consent to "common director" transaction:** *See* ¶ 6:304.1 ff.

4. [6:234] **Removal of Directors:** Directors can be removed from office before the end of their term only under the following circumstances:

a. [6:235] **By shareholder action:** As already discussed, any director or the entire board can be removed from office at any time—with or without cause—by approval of the outstanding shares (*¶ 6:20 ff.*). [Corps.C. § 303(a)]

(1) [6:236] **Limitation to protect cumulative voting:** Unless the entire board is removed at the same time (necessitating election of a new board), no individual director can be removed if the shares voting against their removal, or not consenting in writing to the removal, would have been sufficient to elect that director under cumulative voting. [Corps.C. § 303(a)(1); *see* ¶ 6:21, 6:139] However, this limitation does not apply to "listed" corporations whose articles have eliminated cumulative voting, *unless* the board is classified and serving staggered terms. [Corps.C. § 303(a)(3); *see* ¶ *4:77a ff., 4:88.14*]

(2) [6:236.1] **Limitation to protect class voting:** Similarly, where there is "class voting" (i.e., a class or series of shares entitled to elect one or more members of the board; *see ¶ 3:155*), a director representing a particular class or series cannot be removed except by the required vote of shares of that class or series. [Corps.C. § 303(a)(2); *see ¶ 6:22*]

b. [6:237] ***Not by director action:*** Since directors are elected by the shareholders, the board ordinarily has *no* power to expel one of its members or to exclude them from its meetings. [See *American Ctr. for Ed., Inc. v. Cavnar* (1978) 80 CA3d 476, 496, 145 CR 736, 749—different rule applies to nonprofit corporations since they have no shareholders (superseded by statute on other grounds as stated in *Patton v. Sherwood* (2007) 152 CA4th 339, 346-347, 61 CR3d 289, 294-295); see also Corps.C. §§ 5222(a)(3) (removal of directors without cause in nonprofit public benefit corporation), 7222(a)(3) (removal of directors without cause in nonprofit mutual benefit corporation)]

(1) [6:238] **Exception—felons, incompetents:** However, the Code gives the board authority to declare vacant the office of any director who has been convicted of a felony, or adjudicated incompetent. [Corps.C. § 302]

Under such circumstances, after declaring the office vacant, the board can immediately appoint another director to fill the vacancy it has created. (If the board delays, the shareholders may fill the vacancy.) [Corps.C. § 305; *see ¶ 6:18 ff.*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

c. [6:239] **By court action:** By statute, shareholders holding at least *10%* of the outstanding shares of *any class* (not necessarily voting shares) may sue to remove a director from office on grounds of "fraudulent or dishonest acts or gross abuse of authority." [Corps.C. § 304]

[6:240] Such suit must be filed in the superior court of the county in which the corporation has its principal office. And, the corporation must be made a party to the action. [Corps.C. § 304; *American Ctr. for Ed., Inc. v. Cavnar* (1978) 80 CA3d 476, 496, 145 CR 736, 749 (superseded by statute on other grounds as stated in *Patton v. Sherwood* (2007) 152 CA4th 339, 346-347, 61 CR3d 289, 294-295)]

[6:241] If the court finds in accordance with the shareholders' complaint, it can remove the director from office immediately, and may bar their reelection for a period prescribed by the court. [Corps.C. § 304]

(1) [6:242] **Nonstatutory grounds:** In addition to the statutory authorization above (¶ 6:239 ff.), courts have *inherent equitable power* to remove directors from office. Such power can be exercised on the petition of any person (even if holding *less than 10%* of the outstanding shares). [See *American Ctr. for Ed., Inc. v. Cavnar* (1978) 80 CA3d 476, 499, 145 CR 736, 750 (nonprofit, "nonmembership" corporation) (superseded by statute on other grounds as stated in *Patton v. Sherwood* (2007) 152 CA4th 339, 346-347, 61 CR3d 289, 294-295)]

However, such equitable relief will be denied if plaintiff lacks standing to sue (i.e., not a shareholder, director or other party in interest) or is not entitled to equitable relief (e.g., because of "unclean hands"). [*American Ctr. for Ed., Inc. v. Cavnar*, supra]

d. [6:242.1] **Potential consequences for refusing to acquiesce to removal:** A director does not violate a fiduciary duty (¶ 6:243 ff.) by merely refusing to acquiesce to being removed from office. However, a breach of fiduciary duty may occur if the ousted director engages in egregious conduct after the removal that is not in the corporation's best interests. [*Association for Los Angeles Deputy Sheriffs v. Macias* (2021) 63 CA5th 1007, 1011, 1032-1033, 278 CR3d 487, 493, 509-510—directors violated their fiduciary duties by forming "shadow board" and taking other "ill-advised" steps to try to remain in charge after director's removal]

5. [6:243] **Directors' Duties and Liabilities:** Directors stand in a fiduciary relationship of trust and confidence with the corporation and its shareholders. Accordingly, they owe fiduciary duties of diligence and fidelity in performing their duties. [See generally, S. Radin, The Business Judgment Rule—Fiduciary Duties of Corporate Directors (Wolters Kluwer Law & Bus., 6th ed., 2009)]

a. [6:244] **Fiduciary duty of care:** Each director owes a fiduciary duty of care to the corporation and its shareholders. They must serve "in *good faith*, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including *reasonable inquiry,* as an ordinarily prudent person in a like position would use under *similar circumstances*." [Corps.C. § 309(a) (emphasis added); see also Corps.C. § 2700(a) (SPCs, ¶ *9:82*); compare Corps.C. § 14620(a) (benefit corporations, ¶ *9:552*)]

A director who performs their duties in accordance with this standard "shall have no liability based upon any alleged failure to discharge the person's obligations as a director." [Corps.C. § 309(c); see also Corps.C. § 2700(d) (SPCs); compare Corps.C. §§ 14620(g), 14622(c) (benefit corporations, ¶ *9:561*)]

Cross-refer—limiting director liability for breach of duty of care: Special statutes permit a corporation to greatly limit directors' liability to the corporation for breaching their duty of care; *see ¶ 6:250.1 ff.*

(1) [6:244.1] **Relationship of Corps.C. § 309 to common law:** Courts have ruled that the common law "business judgment" rule has two components—one that immunizes directors from personal liability and another that insulates from court intervention good faith management decisions made in what the directors believe is the corporation's best interest—and that *only the first component is embodied in Corps.C. § 309*. Moreover, the common law rule of judicial deference to the directors' exercise of business judgment has been described as *broader* than the Corps.C. § 309 limitation on liability. [See *Lamden v. La Jolla Shores Clubdominium Homeowners Ass'n* (1999) 21 C4th 249, 257, 87 CR2d 237, 242; *Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 CA4th 1020, 1045, 100 CR3d 875, 897; also see *Scheenstra v. California Dairies, Inc.* (2013) 213 CA4th 370, 386-387, 153 CR3d 21, 35-36]

Corps.C. § 309 became effective in 1977. Most post-1977 cases have not distinguished between (or even acknowledged) these two components of the "business judgment rule." Rather, these cases simply state that the statute was derived from the "business judgment rule" as it existed under California common law. [See *Lehman v. Sup.Ct. (Zamora)* (2006)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

145 CA4th 109, 120-121, 51 CR3d 411, 418-419 (citing text); *Briano v. Rubio* (1996) 46 CA4th 1167, 1177-1179, 54 CR2d 408, 414-415]

(2) [6:245] **"Business judgment rule":** California courts (like courts elsewhere) apply the common law "business judgment rule" in determining directors' liability for breach of their duty of care. Under this rule, courts will not review directors' business decisions, or hold directors liable for errors or *mistakes in judgment*, so long as they were:

• *Disinterested* and *independent*;

• Acting in *good faith*; and

• *Reasonably diligent* in informing themselves of the facts. [See *Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 CA4th 1020, 1045-1046, 100 CR3d 875, 897-898; *Burt v. Irvine Co*. (1965) 237 CA2d 828, 845, 47 CR 392, 407; see also *Palm Springs Villas II Homeowners Ass'n, Inc. v. Parth* (2016) 248 CA4th 268, 279, 204 CR3d 507, 517]

The business judgment rule arises most frequently in derivative actions (shareholders suing on behalf of the corporation; *see* ¶ 6:602 ff.) seeking to hold the directors personally liable for corporate losses resulting from:

• Claimed diversion or *waste* of corporate assets (e.g., payment of excessive compensation);

• Embezzlements by an officer or employee whom the directors had entrusted with corporate funds, despite reason to doubt such person's trustworthiness;

• Errors by officers appointed by the board, where such officers' lack of competence was readily apparent; or

• The directors' own failure to obtain adequate insurance on corporate assets, or to protect the corporation against foreseeable liabilities.

In addition, the business judgment rule may be invoked by directors (or their special litigation committees) in asserting their right to *dismiss* derivative suits as contrary to the corporation's best interests (*see* ¶ 6:630 ff.).

(a) [6:245.1] **Good faith presumed:** Disinterested directors are *rebuttably presumed* to have acted in good faith (i.e., to have believed their decision was in the corporation's best interests). Thus, a plaintiff challenging the board decision has the burden of showing the decision involved a *conflict of interest*, or was made in *bad faith* (e.g., fraudulently) or *without the requisite degree of care and diligence*. [*Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 CA4th 1020, 1045, 100 CR3d 875, 897-898; *Katz v. Chevron Corp.* (1994) 22 CA4th 1352, 1366, 27 CR2d 681, 689—"The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" (internal quotes omitted); see *Biren v. Equality Emergency Med. Group, Inc.* (2002) 102 CA4th 125, 137, 125 CR2d 325, 332—director/shareholder of small medical corporation facing cash-flow emergency acted in good faith in reassigning billing contract despite exceeding her authority under shareholder agreement]

(b) [6:245.2] **Rationale:** The business judgment rule reflects judicial reluctance to "second-guess" directors' business decisions, given the courts' limited expertise in business matters (i.e., business decisions should be made in the boardroom, not the courtroom). Additionally, the rule recognizes that successful businesses involve considerable risk-taking which ought not to be discouraged with threats of liability for mistakes. [See *Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 CA4th 1020, 1045, 100 CR3d 875, 897; *Federal Deposit Ins. Corp. v. Castetter* (9th Cir. 1999) 184 F3d 1040, 1044; also see *Scheenstra v. California Dairies, Inc.* (2013) 213 CA4th 370, 387, 153 CR3d 21, 36]

(c) [6:245.3] **"Disinterested and independent":** To be protected by the business judgment rule, directors' decisions must be "disinterested and independent"—i.e., made without self-interest or undue influence of others. Where a director has (directly or indirectly) a *personal interest* in a corporate decision, their judgment on the matter is *not* entitled to judicial deference under the rule. [See *Gaillard v. Natomas Co.* (1989) 208 CA3d 1250, 1265-1266, 256 CR 702, 711 (*discussed at* ¶ *6:247.11*) (disapproved on other grounds by *Grosset v. Wenaas* (2008) 42 C4th 1100, 1119, 72 CR3d 129, 144, fn. 16); *Kruss v. Booth* (2010) 185 CA4th 699, 728, 111 CR3d 56, 80-81; also see *Katz v. Chevron Corp.* (1994) 22 CA4th 1352, 1367, 27 CR2d 681, 689—"a director is independent when he is in a position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences" (internal quotes omitted)]

1) Application

• [6:245.3a] Business judgment rule did not apply to homeowners association's decision to approve a budget that made individual homeowners within a development pay a greater share of service costs, and allocated less responsibility to a company that owned and rented other homes within the development. The company was a subsidiary of a real estate developer and two of the directors on the HOA's board were officers of the developer. Under the developer's pay structure, the directors' compensation as officers of the developer was affected by the subsidiary company's financial performance. Based on this unrelated personal financial interest, the directors had a material conflict of interest when they approved the budget that benefited the subsidiary company. [*Coley v. Eskaton* (2020) 51 CA5th 943, 948-949, 953, 957, 264 CR3d 740, 744-745, 748, 751-752]

2) [6:245.4] **Comment:** It is unclear what quantum of personal interest is necessary to establish lack of independence. In one case, a director of a corporation that paid over $200,000 in investment banking fees to the director's firm was considered independent (for the purpose of deciding whether the challenged actions were approved by a board comprised of a majority of outside, independent directors) where the corporation's business was less than 0.001% of the firm's total revenues and the director was not personally involved with the account. [*Katz v. Chevron Corp.* (1994) 22 CA4th 1352, 1368, 27 CR2d 681, 690]

(d) [6:245.5] **No liability for "ordinary negligence":** Despite contrary language in Corps.C. § 309(a) (¶ *6:244 ff.*) and some cases, directors will *not* be held liable for a *negligent* judgment (i.e., one a reasonably prudent person would not have made) so long as the *process* leading to the judgment meets business judgment rule requirements. In other words, courts will not "second-guess" the decisions of disinterested directors made with *reasonable diligence in ascertaining the facts* and believed to be in the corporation's best interests. (This is so even if the directors make a bad or "stupid" decision.)

Thus, the business judgment rule standard is one of *gross negligence*—i.e., failure to exercise even slight care. [See *Burt v. Irvine Co*. (1965) 237 CA2d 828, 852-853, 47 CR 392, 407-408; see also *Palm Springs Villas II Homeowners Ass'n, Inc. v. Parth* (2016) 248 CA4th 268, 288, 204 CR3d 507, 524—"there is no conflict between the business judgment rule and negligence, and application of that rule presupposes that reasonable diligence has in fact been exercised" (internal quotes, brackets and ellipsis omitted); *Katz v. Chevron Corp*. (1994) 22 CA4th 1352, 1366, 27 CR2d 681, 689]

(e) [6:246] **Directors must use reasonable care in ascertaining facts:** The "business judgment rule" does not excuse want of ordinary prudence and skill in *ascertaining* the relevant and available facts. Directors may not "close their eyes" to what is going on around them and claim to have been acting responsibly and in good faith. They owe a duty to make such inquiry as a *reasonable person* would make as to matters inviting such inquiry. [See *Palm Springs Villas II Homeowners Ass'n, Inc. v. Parth* (2016) 248 CA4th 268, 279-280, 204 CR3d 507, 517; *Burt v. Irvine Co*. (1965) 237 CA2d 828, 845, 47 CR 392, 407; *Federal Deposit Ins. Corp. v. Castetter* (9th Cir. 1999) 184 F3d 1040, 1046 (but finding for defendant directors)]

1) [6:246.1] **Compare—Delaware law:** In contrast, under Delaware law, directors lose business judgment rule protection only if *grossly* negligent in failing to inform themselves. Mere negligence in ascertaining the facts does not offend the rule. [See *Central Laborers' Pension Fund v. McAfee, Inc.* (2017) 17 CA5th 292, 317-318, 225 CR3d 249, 273 (applying Del. law); *Smith v. Van Gorkom* (Del. 1985) 488 A2d 858, 873 (overruled on other grounds by *Gantler v. Stephens* (Del. 2009) 965 A2d 695, 713, fn. 54) (*discussed at* ¶ *6:247.2*); and *Moran v. Household Int'l, Inc*. (Del. 1985) 500 A2d 1346, 1356 (overruled on other grounds by *Gantler v. Stephens* (Del. 2009) 965 A2d 695, 713, fn. 54)]

However, in taking action *in response to takeover threats*, directors have the burden of showing they made a good faith, "reasonable investigation"; *see* ¶ *6:247.2 ff.* [*Katz v. Chevron Corp.* (1994) 22 CA4th 1352, 1367, 27 CR2d 681, 689]

(3) [6:247] **Liability for failure of oversight:** In *Kanter v. Reed* (2023) 92 CA5th 191, 210, 309 CR3d 375, 388 (case of first impression), a California Court of Appeal expressly adopted Delaware's "*Caremark* standard" for suits alleging failure of director oversight. Under the *Caremark* standard (*In re Caremark International, Inc.* (1996) 698 A2d 959, 967; *Marchand v. Barnhill* (2019) 212 A3d 805, 820-821), the plaintiff must show the directors acted in *bad faith*—i.e., that they completely failed to implement a reporting system or controls, or, having implemented such a system, consciously failed

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

to monitor it. [*Kanter v. Reed*, supra, 92 CA5th at 210-211, 309 CR3d at 388-389 (affirming dismissal following sustaining of demurrer)—no liability under *Caremark* where directors had exercised *some* oversight of corporation's gas storage infrastructure by establishing committee responsible for natural gas safety and receiving safety reports from committee and management]

The *Caremark* standard is *process-oriented*, in that it looks to whether the board made *good faith efforts* to put a board-level monitoring system in place, not at the *effectiveness* of that system. [See *Kanter v. Reed*, supra, 92 CA5th at 211, 309 CR3d at 389; *Marchand v. Barnhill*, supra, 212 A3d at 821-822]

(4) [6:247.1] **Corporate takeovers:** Further, in today's business climate, the business judgment rule has particular importance for directors who permit (or prevent) the takeover of their corporation.

The decisions of incumbent officers and directors in such situations could be motivated by *self-interest*—i.e., what is best for them (e.g., their own self-perpetuation), rather than for the corporation and shareholders. Accordingly, courts closely scrutinize directors' decisions in response to takeover attempts to determine whether they have acted fairly and in good faith.

• [6:247.1a] ***CAUTION*—EXTENSIVE REGULATION OF CORPORATE TAKEOVERS:** Takeovers of *publicly held* corporations are subject to extensive regulation under the Williams Act (15 USC §§ 78m, 78n) and other provisions of the 1934 Act; under rules adopted by the SEC and the stock exchanges; and under the Hart-Scott-Rodino Antitrust Improvements Act (15 USC § 18a). Moreover, administrative agency approval may be required under certain federal regulatory statutes.

In addition, many of the states—*not* including California—have adopted statutes designed to prevent hostile takeovers. Many of these statutes have been held unconstitutional (see *Edgar v. MITE Corp.* (1982) 457 US 624, 643, 102 S.Ct. 2629, 2641). But an Indiana law allowing a target corporation's shareholders to deny voting rights to a potential acquiror has been upheld against challenges under the Williams Act (above) and Commerce Clause. [See *CTS Corp. v. Dynamics Corp. of America* (1987) 481 US 69, 81-84, 107 S.Ct. 1637, 1645-1646]

The above regulations are beyond the scope of this Practice Guide; but practitioners involved in such transactions must be familiar with them.

➪ [6:247.1b] ***PRACTICE POINTERS:*** Before taking any action in response to a takeover, directors must *diligently* inform themselves about all material aspects of the transaction. They cannot unquestioningly accept the conclusions of experts (e.g., investment bankers or lawyers); rather, they must diligently scrutinize their experts' opinions, make such further inquiries and pursue such other alternatives as would be reasonable under the circumstances (*see ¶ 6:246*).

Moreover, the directors must create a *record* (e.g., minutes, memoranda) which clearly demonstrates that (1) they *adequately informed themselves* (¶ 6:246); and (2) their own *self-perpetuation* was *not* a motivating factor in the transaction.

(a) [6:247.2] **"Friendly" takeovers:** Directors who approve and recommend a takeover will *lose* business judgment rule protection where a challenging shareholder can show their actions were tainted by *self-interest*. Example: The target company's managers are granted special concessions as part of the takeover (e.g., a commitment that they will retain their positions or receive substantial separation bonuses).

Likewise, directors may be without business judgment rule protection where they fail to *adequately inform* themselves about the merger. For example, the directors of a publicly held Delaware corporation who agreed to a "friendly" merger lost the protection of the business judgment rule because they failed to make an "informed decision." They agreed to the merger following a two-hour special meeting, without adequate valuation information and without reading the merger agreement. They were held personally liable to the stockholders for the difference between the fair market value of the corporation's stock and the agreed-upon takeover price. [*Smith v. Van Gorkom* (Del. 1985) 488 A2d 858, 874 (overruled on other grounds by *Gantler v. Stephens* (Del. 2009) 965 A2d 695, 713, fn. 54); see *Central Laborers' Pension Fund v. McAfee, Inc.* (2017) 17 CA5th 292, 318, 225 CR3d 249, 273 (applying Del. law)]

1) [6:247.2a] **Burden on plaintiff to rebut presumption of validity:** However, the burden is on the plaintiff challenging the friendly takeover to rebut the presumptions of the business judgment rule (¶ 6:247.2): i.e., plaintiff must specifically allege and show malfeasance or bad faith, or that an improper motive was the sole or primary reason for the directors' actions. [*Eldridge v. Tymshare, Inc.* (1986) 186 CA3d 767, 777, 230 CR 815, 820]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) [6:247.3] **Hostile takeovers:** In recent years, directors of corporations targeted for unfriendly takeovers have developed a variety of defensive tactics ("poison pills"). Again, the directors' actions could be motivated by a desire for self-perpetuation, rather than based on an objective assessment of what is best for the shareholders and other affected interests.

1) [6:247.4] **Presumption of validity inapplicable:** When directors implement defensive tactics against a hostile takeover, they may be *presumed* to be acting to *perpetuate their own control*. As a result, they may lose the protection of the business judgment rule presumption of validity (*see ¶ 6:245*). Reason: Perpetuation of control constitutes a *personal benefit* to the directors—making them "interested" in the transaction.

Thus, the *burden is on the directors* to prove the transaction was (1) entered into in *good faith*; and (2) *inherently fair* to the corporation and other affected interests. [*Heckmann v. Ahmanson* (1985) 168 CA3d 119, 128, 214 CR 177, 183—directors presumed to have acted to perpetuate their control where they agreed to have corporation buy minority's shares at substantial premium in exchange for halt to hostile takeover attempt ("greenmail"); *see ¶ 7:134*]

a) [6:247.5] **California adopts two-prong Delaware test:** California courts appear willing to follow the Delaware courts in this area. Where directors engage in defensive moves to ward off a takeover threat, "the possibility that they may be acting to protect their own interests rather than those of the corporation and shareholders creates 'an enhanced duty which calls for judicial examination at the threshold before protections of the business judgment rule may be conferred.'" [*Katz v. Chevron Corp.* (1994) 22 CA4th 1352, 1367, 27 CR2d 681, 689 (quoting *Unocal Corp. v. Mesa Petroleum Co.* (Del. 1985) 493 A2d 946, 954)]

Accordingly, because of the danger they are motivated primarily by self-interest, directors implementing defensive tactics will *not* be protected by the business judgment rule *unless* they can demonstrate:

- They "had reasonable grounds for believing that a *danger* to corporate policy and effectiveness existed"; *and*

- The defensive tactic was "*reasonable* in relation to the threat posed." [*Katz v. Chevron Corp.*, supra (emphasis added)]

To satisfy the first prong, the directors must show they acted *in good faith* after *reasonable investigation* demonstrated a *threat to their corporation's policies and effectiveness*. This showing is "materially enhanced" by approval of a board comprised of a *majority of outside, independent directors*, especially if the board receives the advice of investment bankers and legal counsel. In determining whether the second prong is met, California (and Delaware) courts use a balancing test to decide whether the tactic was *reasonable in relation to the perceived threat*. [*Katz v. Chevron Corp.*, supra, 22 CA4th at 1367-1369, 27 CR2d at 689-690; *Unocal Corp. v. Mesa Petroleum Co.*, supra, 493 A2d at 955]

b) [6:247.5a] **Shareholder approval alternative:** Alternatively, business judgment rule protection may apply where the directors obtain the approval of a fully informed, uncoerced stockholder vote in approving the transaction or the defensive measures taken. [*Corwin v. KKR Fin'l Holdings LLC* (Del. 2015) 125 A3d 304, 311-312 (applying Del. law) (*discussed further at ¶ 6:247.20*); *see also ¶ 6:247.19*]

However, no California court has yet to adopt Delaware's invocation of business judgment rule protection for directors of *Delaware* corporations even where the procedural protections of a well-functioning special committee and the informed, uncoerced vote of shareholders is utilized and obtained; *see ¶ 6:247.19 ff.*

2) [6:247.5b] **Compare—suits to recover loss of share value:** However, if the directors make a good faith determination that it is in the best interests of the corporation and shareholders that the corporation remain independent, the business judgment rule will protect them against claims that they should be liable for declines in stock prices resulting from their opposition to takeover bids. [See *Panter v. Marshall Field & Co.* (7th Cir. 1981) 646 F2d 271, 295-296]

3) [6:247.6] **Examples of defensive tactics accorded business judgment rule protection:** Under the particular facts of the cases below (¶ 6:247.7 ff.), directors implementing the following types of defensive tactics were held to have met their initial burden of showing their actions were fair, reasonable and taken in good faith, and were thus entitled to the protection of the business judgment rule. (These are primarily out-of-state decisions because there are few California cases on point.)

a) [6:247.7] **Self-tender offer excluding raider ("lollipop"):** Directors may be protected by the business judgment rule where they attempt to defeat a hostile takeover bid by having the corporation extend a tender offer to repurchase the shares of all of its shareholders *except* the raider. (This tactic is termed "lollipop" because it "tastes good" to all the shareholders except the hostile raider.) [See *Unocal Corp. v. Mesa Petroleum Co.* (Del. 1985) 493 A2d 946, 955—discriminatory self-tender offer upheld where directors had good faith belief (based on adequate investigation) that hostile takeover offer was inadequate, and self-perpetuation not a prime motivating factor]

1/ [6:247.8] **SEC limitations:** An SEC "all-holders" rule effectively prohibits discriminatory self-tender offers by companies subject to the 1934 Act, though the SEC may grant exemptions on a case-by-case basis. [See SEC Rel. No. 34-23421 (1986); and Rules 14d-10(f), 13e-4(f) (17 CFR §§ 240.14d-10(f), 240.13e-4(f))]

However, the tactic is still available to corporations not subject to SEC regulation.

b) [6:247.9] **"Poison pill" plans:** Directors who adopt "poison pill" plans may also be protected by the business judgment rule. Here, the corporation issues convertible preferred shares or warrants which give their holders greatly increased rights (e.g., a cash payment or receipt of debt security) if anyone acquires more than a specified percentage of the corporation's shares ("flip-in provision"). And, in a reverse twist ("flip-over provision") if the company is merged with another, the holders may be given the right to purchase a specified amount of the *aggressor's* securities at bargain prices.

These plans can ordinarily be adopted by the directors alone, without shareholder approval (so long as sufficient stock is authorized by the articles). Moreover, they can usually be terminated by vote of the directors (e.g., when the takeover threat has passed).

Such plans vastly increase the cost of a hostile takeover (they are "poison pills" that, if swallowed along with the target company, could financially kill the raider). [See *Versata Enterprises, Inc. v. Selectica, Inc.* (Del. 2010) 5 A3d 586, 599-607—poison pill with 4.99% trigger upheld where directors, in good faith and after reasonable investigation, concluded it was necessary to protect corporation's net operating loss carryforward; *Moran v. Household Int'l, Inc.* (Del. 1985) 500 A2d 1346, 1357—directors' action granting common shareholders rights to acquire $200 of tender offeror's common stock for $100 in event of merger upheld as legitimate exercise of business judgment where directors reasonably believed it would make company less vulnerable to "coercive acquisition techniques"]

1/ [6:247.9a] **Limitation:** Some decisions suggest that since "poison pills" may be used to protect management at shareholder expense, they may not be used to *indefinitely delay* a takeover and, hence, must be cancelled when their sole purpose is to preclude shareholder choice. [See *Grand Metropolitan Pub. LTD. Co. v. Pillsbury Co.* (Del.Ch. 1988) 558 A2d 1049, 1055; *Mai Basic Four, Inc. v. Prime Computer, Inc.* (Del.Ch. 1988) 1988 WL 140221]

c) [6:247.10] **Self-tender offers:** The board of a target corporation may respond to a takeover offer by offering to exchange debt securities containing covenants restricting the sale of the corporation's assets for outstanding common stock. [See *GAF Corp. v. Union Carbide Corp.* (SD NY 1985) 624 F.Supp. 1016, 1034-1035—offer upheld as within directors' informed business judgment under New York law where hostile takeover threatened liquidation of the company]

d) [6:247.11] **"Golden parachutes":** Likewise, a board may furnish "golden parachutes" providing large severance payments for officer-directors and other personnel in event of a change of control. This can extend to a company retirement plan, allowing the board to "vest" specified corporate funds and employee benefits in case of an unfriendly change of control. [See *GAF Corp. v. Union Carbide Corp.* (SD NY 1985) 624 F.Supp. 1016, 1034-1035—upholding "pension parachute" amendment to company's retirement plan as reasonable to protect employees from possible negative effect of control contests]

However, at least one California court has held that the actions of officer-directors in securing "parachute" payments for themselves are *not* protected by the business judgment rule against claims of breach of duty and corporate "waste" … even where the "parachute" payments are approved by "*outside"* (disinterested) directors (i.e., the "parachute" recipients abstain from voting on the matter). [*Gaillard v. Natomas Co.* (1989) 208 CA3d 1250, 1265, 256 CR 702, 711 (disapproved on other grounds by *Grosset v. Wenaas* (2008) 42 C4th 1100, 1119, 72 CR3d 129, 144, fn. 16)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(In addition, such bonus payments may be subject to challenges as to their reasonableness, and to penalty taxation; *see ¶ 6:425.1 ff.*)

e) [6:247.11a] **Combination of tactics:** In one of the few California decisions in this area, a combination of defensive measures adopted by the board of a Delaware corporation was upheld as protected by the business judgment rule. The measures consisted of procuring a bank credit line, decreasing (from 20% to 10%) the amount of stock an acquirer could own without triggering an existing shareholder rights ("poison pill") plan (*see ¶ 6:247.9*), amending the bylaws to eliminate shareholders' rights to call special meetings, and commencing litigation against the raider for inadequate disclosures under the 1934 Act. [*Katz v. Chevron Corp.* (1994) 22 CA4th 1352, 1359, 1373-1375, 27 CR2d 681, 684, 693-695 & fn. 6]

4) [6:247.12] **Compare—defensive tactics *not protected by business judgment rule:*** In contrast, some defensive tactics are so detrimental to the corporation and its shareholders that they justify a *strong inference* that the directors were acting primarily to *perpetuate* themselves. Thus, directors implementing such tactics face a nearly insurmountable burden in proving that they acted in good faith and that the tactic was fair and reasonable.

a) [6:247.13] **"Greenmail" payments:** When directors use corporate funds to purchase shares held by a corporate "raider," they are presumed to be acting to perpetuate their own control, and therefore bear the burden of proving the fairness of the transaction. [*Heckmann v. Ahmanson* (1985) 168 CA3d 119, 128, 214 CR 177, 183, *discussed at ¶ 6:247.4*] (Moreover, greenmail payments are subject to penalty taxation; *see ¶ 7:243.1*.)

b) [6:247.14] **"Scorched earth" provisions:** A strong inference that the directors are acting to perpetuate themselves arises where they implement "scorched earth" provisions. These are measures that become effective on any change of control, and result in great expense to the corporation and any new owners of its stock. They include modifying existing stock-option, retirement and severance pay plans to greatly favor existing employees. [See *Minstar Acquiring Corp. v. AMF Inc.* (SD NY 1985) 621 F.Supp. 1252, 1255-1256, 1259-1261 (applying New Jersey law)]

c) [6:247.15] **Retrospective defensive measures:** *Retrospective* defensive measures (i.e., adopted after the takeover is accomplished) are particularly suspect. Such measures constitute "inequitable conduct," not protected by the business judgment rule. [See *Frantz Mfg. Co. v. EAC Indus.* (Del. 1985) 501 A2d 401, 407-408—corporation issued additional stock to an ESOP to dilute control acquired by "raider"]

d) [6:247.16] **Sales to others at lower price:** Nor will the business judgment rule protect directors who defeat a takeover bid by selling the corporate assets to others at a lower price. [See *Edelman v. Fruehauf Corp.* (6th Cir. 1986) 798 F2d 882, 885-886—directors rejected takeover bid and helped management purchase corporation in leveraged buyout at lower price]

Once a takeover appears inevitable, directors ordinarily have a duty to *maximize* their company's value at a sale for shareholder benefit—i.e., to "sell it to the highest bidder." [*Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* (Del. 1985) 506 A2d 173, 182; *Ivanhoe Partners v. Newmont Mining Corp.* (Del. 1987) 535 A2d 1334, 1344-1345; *Paramount Communications Inc. v. QVC Network Inc.* (Del. 1994) 637 A2d 34, 51—board must abandon planned "friendly" merger in face of much higher competing bid] But this does not necessarily mean directors must conduct a full market survey before approving a proposed buyout, provided they possess reliable evidence with which to evaluate the proposal's fairness. [*Barkan v. Amsted Indus., Inc.* (Del. 1989) 567 A2d 1279, 1287]

Moreover, there may be no such duty to put the company up for sale at the best price when it is being acquired by its *own majority shareholder* (*Kleinhandler v. Borgia* (Del.Ch. 1989) (1989 WL 76299)) *or* when the directors view the long-term potential benefits of a pending merger (including preservation of the corporation's independence, traditions and "culture" and, hence, their continued management) as outweighing the short-term benefits of an immediate higher cash offer (*Paramount Communications, Inc. v. Time Inc.* (Del.Ch. 1989) (1989 WL 79880), aff'd (Del. 1990) 571 A2d 1140, 1152).

e) [6:247.17] **Lock-up options:** A "lockup" option makes the corporation less attractive to a raider by giving another firm (a "white knight") an option to acquire one or more of the target's particularly attractive or profitable subsidiaries (the corporation "locks up" its "crown jewels").

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Directors who adopt this strategy are *not* entitled to business judgment rule protection where such a lock-up option *prevents* a competitive auction to the shareholders' detriment. [See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* (Del. 1985) 506 A2d 173, 182; *Hanson Trust PLC v. ML SCM Acquisition, Inc.* (2nd Cir. 1986) 781 F2d 264, 273-274; *Cottle v. Storer Communication, Inc.* (11th Cir. 1988) 849 F2d 570, 575-577; see also *Mills Acquisition Co. v. Macmillan, Inc.* (Del. 1989) 559 A2d 1261, 1284-1286—board of corporation put "in play" by several bidders may not give lock-up option to bidder whose offer is most favorable to board's entrenchment]

f) [6:247.17a] **Board action to obstruct shareholder voting:** So too, the business judgment rule may not apply to protect board action that infringes on stockholder *voting rights* (e.g., increasing number of directors or issuing additional shares to dilute majority shareholder's control). Indeed, if a court determines the action is primarily designed to thwart an exercise of shareholder voting rights, the directors will bear the burden of demonstrating a *compelling justification* for their action. [*MM Companies, Inc. v. Liquid Audio, Inc.* (Del. 2003) 813 A2d 1118, 1127-1132; *Blasius Indus., Inc. v. Atlas Corp.* (Del.Ch. 1988) 564 A2d 651, 661]

5) [6:247.18] **Compare—"porcupine" provisions:** Another defensive tactic is to add provisions to the articles that make hostile takeovers more difficult. Because such provisions must be approved by the shareholders, their validity is *not* subject to the directors' valid exercise of business judgment. Such "porcupine" provisions include:

• Articles provisions requiring a high percentage of *shareholder* approval (e.g., 75%) for transactions that could result in a change of control (e.g., mergers), unless such transactions are approved by a *supermajority* of the board (e.g., 80%).

• Provisions permitting minority shareholders to require the corporation to *redeem* their shares for cash for a limited time following a change in control.

• Provisions requiring approval of a proposed transaction that could result in a change of control by a majority of shares *other* than those owned by the parties to such a transaction.

• Provisions that require (or permit) the directors to take into account *nonfinancial* factors in considering acquisition offers (e.g., the social, legal, and economic effects on employees, suppliers, customers and the community).

• "Fair price" provisions requiring that shareholders receive *equal consideration* in any tender offer bid (this is to eliminate a "two-tier" tender offer in which a "raider" offers a premium price initially to those shareholders willing to sell early, and then offers the "hold-outs" less—usually a package of securities with little cash).

(However, the SEC "best price" rule now requires all tender offerors to pay all offerees the highest price paid to any one of them; *see ¶ 6:247.8*.)

• Anti-greenmail provisions *prohibiting* the corporation from repurchasing at a premium stock owned by holders of a specified percentage of shares (e.g., 5% or more) without shareholder approval.

(5) [6:247.19] **Effect of well-functioning special committee and informed shareholder vote:** Delaware law permits directors of Delaware corporations to rely upon business judgment rule protection even in transactions where higher standards of review ("enhanced scrutiny" and "entire fairness") would otherwise apply so long as certain procedural protections are followed. Thus, even in a merger or buyout involving a controlling stockholder, the business judgment standard of review will apply where the board adopts the following procedural protections:

• The controlling stockholder conditions the proposed transaction on the approval of *both* a *special committee* of the board of directors and a majority of the *minority* stockholders;

• The special committee is *independent of the controlling stockholder*;

• The special committee is empowered to *freely select its own advisors* and to say *"no"* definitively to the proposed takeover;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The special committee meets its duty of care in negotiating a *fair price* with the controlling stockholder;

• The vote of the minority stockholders in approving the buyout is *informed*; and

• There is no coercion of the minority by the controlling stockholder. [*Kahn v. M & F Worldwide Corp*. (Del. 2014) 88 A3d 635, 645 (overruled on other grounds by *Flood v. Synutra Int'l, Inc*. (Del. 2018) 195 A3d 754, 766-768, fn. 81 (also holding due care standard is judged by gross negligence))]
However, no California court has yet adopted Delaware's business judgment rule protection where these procedural protections are observed.

(6) [6:247.20] **Effect of informed, voluntary vote of disinterested stockholders:** As stated above (¶ *6:247.19*), under Delaware law, "enhanced scrutiny" of board action may apply to transactions even where no controlling shareholder is involved, such as a sales auction of the company or the adoption of defensive measures to thwart a hostile takeover. In such circumstances, the business judgment rule will apply so long as the transaction is approved by an *informed, voluntary vote of disinterested stockholders*. [*Corwin v. KKR Fin'l Holdings LLC* (Del. 2015) 125 A3d 304, 311-312]

Here again, however, no California court has yet adopted this standard.

(7) [6:248] **Reliance on reports from others:** Of necessity, directors must rely on information obtained from management and others. Therefore, as long as they acted in good faith, and after reasonable inquiry as to matters inviting inquiry, directors are not personally liable for decisions made in reliance upon information and reports (including financial statements and data) prepared or presented by:

• Any *officer or employee* of the corporation whom the director believes to be reliable and competent as to the matters presented; or

• Any *committee* of the board (of which the director is not a member) as to matters within their designated authority, if the director believes such committee merits confidence. [Corps.C. § 309(b)(1), (3); see also Corps.C. §§ 2700(b)(1), (3) (SPCs, ¶ *9:83*), 14620(e) (benefit corporations, ¶ *9:560*)]
(a) [6:248.1] **What constitutes a "report":** What suffices for a "report" for this purpose under California law is not entirely clear. However, under a Delaware statute (Del.Gen.Corp.L. § 141(e)) similar to Corps.C. § 309(b), it has been held the "report" must be "pertinent" to the decision at hand and otherwise be entitled to good faith reliance by the board. [See *Smith v. Van Gorkom* (Del. 1985) 488 A2d 858, 875—20-minute oral presentation by board chairman as to terms of merger agreement was not "report" where chairman had not read agreement (overruled on other grounds by *Gantler v. Stephens* (Del. 2009) 965 A2d 695, 713, fn. 54)]

[6:248.2 - 6:248.4] ***Reserved.***

(8) [6:248.5] **Reliance on expert opinion:** Directors are also entitled to rely on advice and opinions given by counsel, independent accountants or other experts as to matters that the director believes to be within such person's professional or expert competence. If the advice turns out to be wrong, the directors are not liable so long as their reliance was in good faith, after reasonable inquiry as to any matters inviting inquiry and without knowledge that would cause their reliance to be unwarranted. [Corps.C. § 309(b)(2); see also Corps.C. §§ 2700(b)(2) (SPCs), 14620(e) (benefit corporations, ¶ *9:560*); and *PMC, Inc. v. Kadisha* (2000) 78 CA4th 1368, 1386-1387, 93 CR2d 663, 676]

➪ [6:248.6] ***PRACTICE POINTER:*** Be prepared to give *specific* advice to the directors as to what is expected of them under the "business judgment" rule.

Advise them (in writing, if appropriate) that, at a minimum, "reasonable care" requires:

• That they attend board meetings whenever possible;

• That if it is necessary to miss a meeting, that they notify the secretary, in advance if possible, stating the reason why they cannot attend, and that they confirm this in writing to the corporation (keeping a copy of the writing), and that they later obtain full information as to everything that transpired at the meeting;

• That they give careful attention to the selection and supervision of the officers of the corporation, and exercise reasonable care in determining that each is competent to perform the duties of such office;

• That they require management to produce *adequate*, periodic financial reports, that they review such reports carefully, and *ask questions* regarding any entries which they do not understand or agree with;

• That they make it a point to stay informed as to the business problems and policies of the corporation; and

• That if they dissent or disagree with any action taken by the board, that the minutes of the meeting reflect such dissent.

(9) [6:249] **Limited duty to creditors when corporation insolvent:** Contrary to what some earlier cases may have stated, the corporation's insolvency does *not* shift the directors' duty of loyalty from the corporation and its shareholders to the corporation's creditors. Rather, under the "trust-fund" doctrine, directors of an insolvent corporation have a *limited* "*extracontractual*" duty (i.e., a duty arising out of the contractual relationship between the corporation and its creditors) to *avoid* actions that *improperly divert, dissipate or risk corporate assets* that might otherwise be used to pay creditors' claims. Examples of such improper acts include self-dealing (payment of corporate debts owed to directors or entities in which the directors have a financial interest) and preferential treatment of some creditors over others. [*Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 CA4th 1020, 1040-1041, 100 CR3d 875, 893-894]

(a) [6:249.1] **No fiduciary duty to creditors when corporation in "vicinity" of insolvency:** The limited extracontractual duty to creditors arises only when the corporation is *insolvent*, an admittedly imprecise concept subject to multiple definitions. There is *no* fiduciary duty to creditors by directors of a corporation operating in the "zone" or "vicinity" of insolvency. These undefined and amorphous concepts are even less objectively determinable than actual insolvency, and cannot serve as the basis for creating a duty to creditors that conflicts with the directors' duty of loyalty to the corporation and its shareholders. [*Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 CA4th 1020, 1041-1043, 100 CR3d 875, 894-895 & fn. 23; see *North American Catholic Educational Programming Found., Inc. v. Gheewalla* (Del. 2007) 930 A2d 92, 100-103]

(b) [6:249.2] **Applicability of "business judgment" rule:** The directors' extracontractual duty to an insolvent corporation's creditors, like the directors' duty of care to the shareholders, is protected by the "business judgment" rule. Directors will not be liable to creditors under corporate common law for acts that arguably diminished the creditors' recovery so long as the directors were personally disinterested and their acts were performed in good faith and following reasonable investigation (*see ¶ 6:245 ff.*). [*Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 CA4th 1020, 1044-1049, 100 CR3d 875, 896-900]

(c) [6:249.3] **Bondholders treated as creditors:** Bondholders are in essence corporate creditors. Like creditors, their relationship with the corporation is solely contractual in nature and their only legitimate business expectation is to be paid in accordance with the contract. Absent insolvency (*¶ 6:249*), neither the corporation nor its directors owe any fiduciary duty to bondholders. [*Pittelman v. Pearce* (1992) 6 CA4th 1436, 1444-1446, 8 CR2d 359, 364-366—no duty owed to holders of corporate bonds whose credit rating and market value fell after highly leveraged buyout]

(10) [6:250] **Claim arising from *prebankruptcy* conduct *not preempted by bankruptcy law:*** Federal bankruptcy law may preempt certain state law claims arising from and occurring during bankruptcy proceedings (e.g., malicious prosecution action for events taking place within bankruptcy court or claim that filing of bankruptcy petition constituted abuse of process). However, a claim that directors improperly placed a corporation in bankruptcy to allow its controlling shareholder to sell the corporation's assets to a secured creditor that was a subsidiary of the controlling shareholder was *not* preempted … because it concerned conduct that occurred *prior to* bankruptcy. [*Davis v. Yageo Corp.* (9th Cir. 2007) 481 F3d 661, 678-679 (*discussed further at ¶ 6:345*)]

[6:250a - 6:250d] *Reserved.*

(11) [6:250e] **Statute of limitations on action for breach of duty of care?** One case held that Corps.C. § 309 codifies the directors' duty of care, and hence the CCP § 359 three-year statute of limitations for actions on a "liability created by law" governs actions based on breach of that duty. [*Smith v. Sup.Ct. (Bonita Park Homeowners Ass'n)* (1990) 217 CA3d 950, 953-954, 266 CR 253, 254-255]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

But later authority disagrees: Because the directors' duty of care existed at common law, Corps.C. § 309 did not "create" that duty within the meaning of CCP § 359. The appropriate statute of limitations appears to be the CCP § 343 four-year "catch-all" limitations period applicable to actions for which no other limitations period is provided. [*Lehman v. Sup.Ct. (Zamora)* (2006) 145 CA4th 109, 114-122, 51 CR3d 411, 414-419; *Briano v. Rubio* (1996) 46 CA4th 1167, 1173-1180, 54 CR2d 408, 411-415]

(12) [6:250.1] **Limiting director liability for breaches of due care:** If the articles so provide (*see ¶ 4:88.1*), directors may be relieved from personal liability to the corporation for monetary damages for some breaches of their duty of care to the corporation and its shareholders (*¶ 6:244*). [Corps.C. § 204(a)(10); see also Corps.C. § 2603(a)(10) (SPCs, *¶ 9:43*)]

➪ [6:250.2] ***PRACTICE POINTER:*** Existing corporate clients should be advised of their option to limit directors' liability by amending the articles. The corporation should act promptly because such an amendment is *not retroactive*—i.e., the corporation cannot wait until after a suit is filed to insulate directors from personal liability (*see ¶ 6:250.9*).

➪ [6:250.3] ***PRACTICE POINTER:*** Even if the corporation adopts such an articles provision, be sure to advise directors *always* to use reasonable care and diligence (*see "Practice Pointer" at ¶ 6:248.6*). Reason: There are important limitations on the extent to which directors may be insulated from personal liability (¶ 6:250.4 ff.).

(a) Limitations

1) [6:250.4] **No insulation from direct shareholder actions:** Directors may be relieved of liability *only to the corporation*—i.e., from direct suits against them by the corporation or *derivative* suits brought by shareholders on the corporation's behalf (*see ¶ 6:598 ff.*). Directors remain personally liable in connection with *direct* shareholder suits, whether brought individually or as a class action. (However, shareholders may not bring a direct action for damages against directors on the theory that their alleged wrongdoing decreased the value of the shareholders' stock; the corporation itself must bring such an action, or a derivative suit must be brought on the corporation's behalf. *See ¶ 6:601.1.*) [Corps.C. § 204(a)(10); see also Corps.C. § 2603(a)(10) (SPCs, *¶ 9:43*)]

2) [6:250.5] **No insulation against equitable relief:** In addition, directors may be insulated only against *monetary* damages liability to the corporation. They remain subject to other forms of relief—e.g., injunctions or other equitable orders. [Corps.C. § 204(a)(10); see also Corps.C. § 2603(a)(10) (SPCs, *¶ 9:43*)]

3) [6:250.6] **No insulation from liability for highly culpable misconduct ("seven deadly sins"):** The articles may insulate directors from damages liability for *negligence* or *gross negligence*, but may *not* relieve them from liability for the following types of *egregious* misconduct:

- *Intentional misconduct*, or knowing and culpable violations of law (Corps.C. § 204(a)(10)(A)(i));
- Conduct the director believes contrary to the corporation's or shareholders' best interests, or that involves an *absence of good faith* (Corps.C. § 204(a)(10)(A)(ii));
- Transactions in which the director derives an *improper personal benefit* (Corps.C. § 204(a)(10)(A)(iii));
- *Reckless disregard* for the director's duty to the corporation or its shareholders when the director was (or should have been) aware in the ordinary course of duty of a risk of serious injury to the corporation or its shareholders (Corps.C. § 204(a)(10)(A)(iv); see *Kanter v. Reed* (2023) 92 CA5th 191, 208, 309 CR3d 375, 387—"reckless disregard" of duties occurs when director intentionally acts or fails to act in accordance with duties, knowing or having reason to know said conduct creates substantial risk of serious harm to corporation or shareholders), *discussed at* ¶ 6:247;
- *Unexcused inattention*, amounting to an "*abdication*" of a director's duty to the corporation or its shareholders (Corps.C. § 204(a)(10)(A)(v); see *Kanter v. Reed* (2023) 92 CA5th 191, 208-209, 309 CR3d 375, 387—"abdication" is act of renouncing or abandoning privileges or duties and requires intentional decision), *discussed at* ¶ 6:247;
- Transactions in which a director has a *conflict of interest* (see Corps.C. § 310, *¶ 6:286 ff.*); or
- Prohibited corporate loans or distributions (see Corps.C. § 316, *¶ 7:142 ff.*).

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [6:250.6a] **Compare—SPC directors:** The ban on indemnification for the "seven deadly sins" applies to SPC directors, but with some variations that take into account the SPC's special purpose; *see ¶ 9:43*.

b) [6:250.7] **Comment:** There are many ambiguities in the foregoing that the courts will have to resolve. It is unclear, for example, what distinguishes "a knowing and culpable violation of the law" from "intentional misconduct"; or how conduct a director believes not to be in the corporation's or shareholders' best interests differs from an "absence of good faith"; or what constitutes an "improper personal benefit."

Similarly, courts will have to decide how to apply the "reckless disregard" of duty standard—e.g., whether to apply a lesser standard than scienter as required in SEC Rule 10b-5 cases (¶ 6:371 ff.); and will have to delineate what degree of neglect constitutes "an unexcused pattern of inattention" amounting to an "abdication" of duty.

4) [6:250.8] **Inapplicable to officers:** Only *directors* may be insulated from liability by the articles. Corporate *officers* may *not* be relieved from liability arising from their conduct as officers. This is so even if an officer is also a director, or the officer's actions have been ratified by the directors. [Corps.C. § 204(a)(10)(C); see also Corps.C. § 2603(a)(10)(C) (SPCs)]

This means "inside" directors (i.e., directors who are also corporate officer-employees) remain exposed to liability for their conduct *as officers*.

5) [6:250.9] **Not retroactive:** Finally, such an articles provision only limits directors' liability for misconduct occurring *after* the provision was adopted and became effective. [Corps.C. § 204(a)(10)(B); see also Corps.C. § 2603(a)(10)(B) (SPCs)]

[6:250.10 - 6:250.14] ***Reserved.***

(13) [6:250.15] **Special statutory provisions applicable to SPC directors:** *See ¶ 9:91 ff.*

(14) [6:250.16] **Special statutory provisions applicable to benefit corporation directors:** *See ¶ 9:552 ff.*

(15) [6:251] **Compare—federal securities laws:** Directors of corporations whose shares are sold in a registered offering under the Securities Act of 1933 are subject to an even higher standard of care: They are personally liable for false statements or material omissions in the registration statement, *unless* they can prove "*due diligence*." And "due diligence" requires *personal* inquiry to *verify* the correctness of the registration statement (i.e., reliance on reports from management is *not* sufficient). [SA § 11 (15 USC § 77k); see *Escott v. BarChris Const. Corp.* (SD NY 1968) 283 F.Supp. 643, 683]

(16) [6:251.1] **Compare—liability for negligence or intentional torts:** Directors cannot be held *vicariously* liable for corporate torts in which they did not personally participate.

However, directors *are* liable to *third persons* injured by the directors' *own tortious conduct* regardless of whether they acted on behalf of the corporation or whether the corporation is also liable. [*Frances T. v. Village Green Owners Ass'n* (1986) 42 C3d 490, 504, 229 CR 456, 463; *PMC, Inc. v. Kadisha* (2000) 78 CA4th 1368, 1379-1381, 93 CR2d 663, 670-672; see *Fleet v. Bank of America N.A.* (2014) 229 CA4th 1403, 1412, 178 CR3d 18, 26, fn. 9]

(a) [6:251.2] **Rationale:** Under common law negligence principles, directors owe a duty to refrain from conduct that imposes an unreasonable risk of injury to third parties. This duty is separate and distinct from the directors' fiduciary duty to the corporation.

Thus, a director's action may satisfy their duty of care to the corporation under Corps.C. § 309 (*¶ 6:244*) but *not* satisfy the director's common law duty of care to *third persons*. [See *Frances T. v. Village Green Owners Ass'n* (1986) 42 C3d 490, 506-507, 229 CR 456, 464-466; *PMC, Inc. v. Kadisha* (2000) 78 CA4th 1368, 1381, 93 CR2d 663, 671-672]

(b) [6:251.3] **Requirements for third party tort action against director:** To maintain a tort claim against directors in their personal capacity, plaintiff must show:

1) The directors:

• *Specifically authorized*, directed or participated in the allegedly tortious conduct; *or*

• Although they specifically knew or *reasonably should have known* that some hazardous condition or activity under their control could injure plaintiff, they *negligently or intentionally failed to take* or order appropriate action to avoid the harm; and

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2) "[A]n ordinarily prudent person, knowing what the director knew at that time, would *not* have acted similarly under the circumstances." [*Frances T. v. Village Green Owners Ass'n* (1986) 42 C3d 490, 509, 229 CR 456, 466-467 (emphasis added); see *Balsam v. Trancos, Inc.* (2012) 203 CA4th 1083, 1109-1111, 138 CR3d 108, 128-129; *PMC, Inc. v. Kadisha* (2000) 78 CA4th 1368, 1381, 93 CR2d 663, 671-672; and *Armato v. Baden* (1999) 71 CA4th 885, 894, 84 CR2d 294, 299-300]

(c) Examples

• [6:251.4] A condominium association's directors who *negligently failed to provide* adequate lighting were personally liable when a unit owner suffered injuries in a criminal assault. [*Frances T. v. Village Green Owners Ass'n* (1986) 42 C3d 490, 509-511, 229 CR 456, 467-469]

• [6:251.4a] The directors/shareholders of a corporation whose employees intentionally misappropriated trade secrets from their former employer were personally liable where the directors knew, or had reason to know, of the misappropriation but *unreasonably failed to take action* that would have prevented ongoing injury to the former employer. [*PMC, Inc. v. Kadisha* (2000) 78 CA4th 1368, 1385-1386, 93 CR2d 663, 675]

• [6:251.4b] An officer/director/shareholder of a corporation that constructed a defective patio and driveway was personally liable to the homeowners: He did not merely make a corporate policy decision that was carried out by someone else; rather, he personally bid and negotiated for the job, participated in and directed construction, and made the decisions to use cheaper materials and construction methods that resulted in the defects. [*Michaelis v. Benavides* (1998) 61 CA4th 681, 686, 71 CR2d 776, 779]

• [6:251.4c] CEO was not liable to email recipient under "Anti-Spam Law" (Bus. & Prof.C. § 17529 et seq.) and Consumer Legal Remedies Act (Civ.C. § 1750 et seq.) where CEO was minimally involved with the company's operations, did not participate in most of its decisions, and did not knowingly consent to or approve any of the alleged unlawful acts. Moreover, the CEO reasonably relied on a consultant's recommendation even though it turned out to be incorrect. [*Balsam v. Trancos, Inc.* (2012) 203 CA4th 1083, 1109-1111, 138 CR3d 108, 128-129]

(d) [6:251.5] **Exception for volunteer directors of specified *nonprofit corporations:*** Various provisions of the Nonprofit Corporation Law insulate *un*compensated (or "volunteer") directors and officers of specified nonprofit corporations from monetary liability for negligent acts or omissions in the performance of their duties, *provided certain conditions are satisfied*. [See, e.g., Corps.C. §§ 5047.5, 5239, 7231.5, 9247]

Moreover, even assuming a negligence cause of action may be maintained, leave of court is required before filing a complaint against any *uncompensated* director or officer of certain statutorily-specified nonprofit corporations. [CCP § 425.15(a); and see CCP § 425.15(e)(1) for list of nonprofit corporation officers and directors to whom leave of court prerequisite applies]

b. [6:252] **Fiduciary duty of loyalty:** In addition to the fiduciary duty of care (¶ 6:244 ff.), directors owe a fiduciary duty of *loyalty* to the corporation they serve. "Loyalty" means placing the corporation's and stockholders' interests ahead of any other business or personal interests of the director. This duty is generally encountered in connection with things directors must *not* do—i.e., they must not compete with the corporation, take personal advantage of "corporate opportunities," act with any conflict of interest, etc. (*See "Conflict of Interest Limitations,"* ¶ 6:285 ff.)

(1) [6:252.1] **Not affected by articles:** Directors' duty of loyalty is not affected by an articles provision limiting director liability for breaches of their duty of care (¶ 6:250.1 ff.). [See Stats. 1987, Ch. 1203, § 4—"It is not the intent of the Legislature by this act to change case law or statutory law regarding the duty of loyalty of a director"]

(2) [6:252.2] **Applicable to corporate general partners of limited partnership:** The directors' duty of loyalty is broad in scope; it extends not only to the corporation's shareholders, but also to the limited partners of a limited partnership of which the corporation is a general partner. [See *In re USACafes, L.P. Litig.* (Del.Ch. 1991) 600 A2d 43, 49]

(3) [6:252.3] **Jury trial right in breach of fiduciary duty action:** Under California law, whether a plaintiff has a jury trial right for a breach of fiduciary duty claim depends on whether the "gist" of the action is *legal* (entitling plaintiff to jury trial) or *equitable* (no jury trial right). Under that test, a claim that a director or majority shareholder breached a fiduciary duty *owed to minority shareholders* is considered *equitable* in nature and thus *not* triable by jury. [See *Central Laborers' Pension Fund v. McAfee, Inc.* (2017) 17 CA5th 292, 344-350, 225 CR3d 249, 294-300; *Interactive Multimedia Artists,*

Inc. v. Sup.Ct. (Allstate Ins. Co.) (1998) 62 CA4th 1546, 1555-1556, 73 CR2d 462, 468-469] By contrast, a Corps.C. § 309 claim for damages based on a director's breach of fiduciary duty *owed to the corporation* is *legal* in nature and thus triable by jury. [*ZF Micro Solutions, Inc. v. TAT Capital Partners, Ltd.* (2022) 82 CA5th 992, 1000-1002, 298 CR3d 385, 390-393 (apparent case of first impression)]

(4) [6:252.4] **Compare—no duty of loyalty to warrant holders:** *See ¶ 6:345.2*.

c. [6:253] **Statutory liabilities:** In addition to such liability as may exist from breach of their fiduciary duties, directors are subject to specific statutory liability for certain acts or omissions:

(1) [6:253.1] **False reports or accounting entries:** Directors (as well as officers, employees and corporate "agents") may be jointly and severally liable for making knowingly false statements or entries in the corporate books, minutes, records or accounts, or in any prospectus, report, circular, certificate, financial statement, balance sheet, public notice or document respecting the corporation or its shares, assets, liabilities, capital, dividends, business, earnings or accounts. (Of course, liability attaches only to the extent of actual damages suffered by the corporation or any person who relied on the falsities and was injured thereby.) [Corps.C. § 1507; see also Corps.C. § 3503 (SPCs, *¶ 9:239*)]

(2) [6:254] **Unlawful dividends:** A director may be personally liable to creditors or preferred shareholders injured as a result of the director's authorizing (or failing to vote against) unlawful distributions to the shareholders. [Corps.C. § 316(a); *¶ 7:156*]

(3) [6:255] **Improper liquidation distributions:** A director may also be personally liable to creditors for authorizing (or failing to vote against) distributions to the shareholders in liquidation of the corporation, without having first paid the creditors or providing adequately for their payment. [Corps.C. § 316(b); *¶ 8:942*]

(4) [6:256] **Unauthorized loans or guarantees:** A director who approves (or fails to vote against) the corporation's loaning money or guaranteeing certain loans, without the approval of the shareholders, is personally liable for any losses to the corporation. The prohibited loans are those to any officer or director of the corporation (or its parent or subsidiary); or to *any* person based solely upon the security of the corporation's own shares. [Corps.C. §§ 315, 316(c); *¶ 6:479*]

[6:256.1 - 6:256.4] ***Reserved.***

(5) [6:256.5] **ERISA malfeasance:** To the extent directors are also ERISA fiduciaries (e.g., acting as trustees of an employee stock ownership plan), they are subject to ERISA fiduciary standards, including duties of loyalty and care, prohibitions against self-dealing, and the "prudent person" standard (i.e., to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent [person] acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"). [29 USC §§ 1002(21)(A)(i), 1104(a)(1), 1106(b)(1); *Fifth Third Bancorp v. Dudenhoeffer* (2014) 573 US 409, 418-425, 134 S.Ct. 2459, 2467-2471 (*discussed further at ¶ 6:406.6 ff.)*; *Johnson v. Couturier* (9th Cir. 2009) 572 F3d 1067, 1075-1078 (*discussed further at ¶ 6:438.2*); see *Retirement Plans Committee of IBM v. Jander* (2020) 589 US 49, 50-51, 140 S.Ct. 592, 594 (per curiam)]

(6) [6:257] **Criminal liabilities:** In addition to the foregoing civil liabilities, it is a crime for a director to:

- "knowingly and willfully" issue shares in violation of the law and with intent to defraud future shareholders or creditors (Corps.C. § 2251);
- "knowingly and with dishonest or fraudulent purpose" allow the corporation to distribute dividends which defraud creditors or preferred shareholders (Corps.C. § 2253);
- "knowingly" be a party to any false statement or entry in the corporate records, or to any fraudulently exaggerated report or other document which would tend to give the corporation's stock greater value than it actually possesses (Corps.C. § 2254); or
- "knowingly" refuse to make any book entry or post any notice required by law in the manner required by law (Corps.C. § 2254).

[6:258 - 6:261] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 6-D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

D. Corporate Officers

1. [6:262] Required Officers
    - a. [6:264] Same person holding several offices
    - b. [6:265] Duties of particular officers
2. [6:266] Election and Removal of Officers
    - a. [6:266.1] Compare—resignation
    - b. [6:267] Compare—contract rights
    - c. [6:267.5] Compare—wrongful termination in violation of public policy
        - (1) [6:267.6] Foreign corporation's wrongful termination of California officer—suit not affected by "internal affairs" doctrine
3. Authority of Corporate Officers
    - a. [6:268] Dealings with third persons
        - (1) [6:269] Actual authority
            - (a) [6:270] Proof
        - (2) [6:271] Apparent authority
            - (a) [6:272] Requirements
            - (b) [6:273] Application
        - (3) [6:274] Agency power of officers
            - (a) [6:275] Comment
        - (4) [6:276] Compare—corporate instruments executed by certain officers
            - (a) [6:276.1] Signature of *two officers* required
    - b. [6:277] Effect of limitations on officers' authority
        - (1) [6:278] As against third persons
        - (2) [6:279] As between officer and corporation
4. [6:280] Duties and Liabilities of Officers
    - a. Duty of care
        - (1) [6:281] No *statutory duty*
            - (a) [6:281.1] Exception—benefit corporations
        - (2) [6:281.2] Common law duty
        - (3) [6:281.3] Liability not limited by articles
    - b. [6:282] Fiduciary duty of loyalty
        - (1) [6:282.1] Duty remains despite loss of authority
            - (a) [6:282.2] Rationale
        - (2) [6:282.3] Compare—"nominal" officer

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(3) [6:282.4] Compare—no duty of loyalty to warrant holders
(4) [6:283] *Caution*—duty of loyalty (and care) owed by *all employees*
c. [6:283e] False reports or accounting entries
d. [6:283.1] Liability of corporate signatories
(1) [6:283.3] Compare—personal liability not avoided by adding corporate title to signature
e. [6:283.4] Liability for corporate torts
(1) [6:283.5] Compare—real estate broker-officer not per se liable for failure to supervise corporate employee
(2) [6:283.6] Compare—licensed contractor-officer not per se liable for corporation's construction operations
f. Criminal liabilities
(1) [6:284] Corporate reports
(2) [6:284a] Concealed hazards
g. Liability for unpaid taxes
(1) [6:284.1] Federal tax liability
(a) [6:284.1a] Who is “responsible officer”
(b) [6:284.1b] No “intent to defraud” or other bad motive required
1) [6:284.1c] Gross negligence as “willfulness”
(c) [6:284.2] 100% penalty assessment
1) [6:284.2a] Corporation's liability for penalties
(d) [6:284.2d] Criminal liability
(2) [6:284.2e] State tax liability
(a) [6:284.2f] Unemployment insurance contributions
(b) [6:284.2g] Sales taxes
h. Liability under environmental laws
(1) [6:284.3] CERCLA
(2) [6:284.3a] Underground storage tanks
i. [6:284.4] Liability under securities laws
(1) [6:284.5] Rule 10b-5 primary liability for signing SEC filing containing misrepresentations
(a) [6:284.5a] “Control person” (vicarious) liability
(b) [6:284.5b] Compare—Sarbanes-Oxley filing
(2) [6:284.6] Corps.C. § 25504 vicarious liability re offering fraud or failure to qualify
(a) [6:284.7] Lack of knowledge as defense
(3) [6:284.8] “Insider trading” liability
(4) [6:284.9] Executive compensation “clawback” for financial statement irregularities (“listed” companies)
j. Liability for unpaid employee compensation
(1) [6:284.11] No personal liability under California statutes
(a) [6:284.12] No tort liability
(b) [6:284.13] Compare—civil penalties
(2) [6:284.16] Potential liability under federal law
(a) [6:284.17] Interaction of state and federal law
(b) [6:284.18] “Economic reality” test
k. [6:284.19] Liability for deceptive marketing under Federal Trade Commission Act and related laws

1. [6:262] **Required Officers:** A corporation must have the following officers:

- A president and/or a chairperson of the board (who may be given the title of chair of the board, chairperson of the board, or chairperson);

• A secretary; and

• A chief financial officer (customarily, also the "treasurer"). [Corps.C. § 312(a); see Corps.C. § 156.6; *see also* ¶ *4:334*]
In addition, a corporation *may* have such other officers, with such titles and duties as provided in its bylaws; or as determined by the board of directors as necessary to enable the corporation to sign instruments and share certificates. [Corps.C. § 312(a)]

[6:263] ***Reserved.***

a. [6:264] **Same person holding several offices:** Unless the articles or bylaws provide otherwise, any number of offices may be held by the same person: i.e., the same person could be president, secretary and chief financial officer. [Corps.C. § 312(a)]
(But, for practical reasons, at least the president and secretary should be different persons; *see* ¶ *4:337*.)

b. [6:265] **Duties of particular officers:** The duties of each officer are generally provided in the corporate bylaws (*see* ¶ *4:335*). Unless the bylaws provide differently, the president (or board chairperson, if there is no president) is the "general manager and chief executive officer of the corporation." [Corps.C. § 312(a)]

2. [6:266] **Election and Removal of Officers:** Unless the articles or bylaws provide otherwise, the officers of the corporation serve at the pleasure of the board (i.e., they are elected by the board and may be removed from office at any time by the board). [Corps.C. § 312(b)]

a. [6:266.1] **Compare—resignation:** Corporate officers may resign at any time upon written notice to the corporation. [Corps.C. § 312(b)] Although the statute calls for a written resignation, an officer's *unequivocal oral* resignation should also be effective (though perhaps not until accepted by the board of directors). [See *Wylie v. Marley Co.* (10th Cir. 1989) 891 F2d 1463, 1469, noting that Kansas resignation provision at issue is identical to Calif. statute]

b. [6:267] **Compare—contract rights:** The board's removal of a person from office has no effect on whatever rights that person may have under contract of employment with the corporation. Conversely, an officer's resignation does not absolve them from liability under any contract to serve the corporation. [Corps.C. § 312(b); see *Bell v. Sup.Ct. (20th Century Ins. Co.)* (1989) 215 CA3d 1103, 1108-1109, 263 CR 787, 789—§ 312(b) creates "at-will" presumption which can be overcome by terms of express or implied contract]

[6:267.1 - 6:267.4] ***Reserved.***

c. [6:267.5] **Compare—wrongful termination in violation of public policy:** An officer terminated for a reason that violates public policy (e.g., whistle-blowing) may have a tort action for damages against the corporation. California law "has long recognized that claims for wrongful termination in violation of public policy serve vital interests insofar as they impose liability on employers who coerce their employees to engage in criminal or other harmful conduct, or employers who retaliate against their employees for speaking out against such conduct." [See *Lidow v. Sup.Ct. (International Rectifier Corp.)* (2012) 206 CA4th 351, 362-364, 141 CR3d 729, 736-738; and detailed discussion in Chin, Wiseman, Callahan & Lowe, *Cal. Prac. Guide: Employment Litigation* (TRG), Ch. 5]

(1) [6:267.6] **Foreign corporation's wrongful termination of California officer—suit not affected by "internal affairs" doctrine:** A conflict of laws problem may arise when a former corporate officer brings a wrongful termination action in California against a *foreign* corporation, as may occur when the foreign corporation is based or doing business in California, or the officer resides in California. Under the "internal affairs" doctrine (¶ *3:4.1 ff.*), the corporation's removal of an officer is an internal matter that would ordinarily be governed by the laws of the corporation's state of incorporation. However, removing an officer for reasons that *violate public policy* "goes beyond internal governance and touches upon broader public interest concerns that California has a vital interest in protecting." Hence, the officer may maintain a California action for wrongful termination in violation of public policy regardless of the corporation's authority to remove officers under the laws of its state of incorporation. [*Lidow v. Sup.Ct. (International Rectifier Corp.)* (2012) 206 CA4th 351, 362-364, 141 CR3d 729, 736-738]

3. Authority of Corporate Officers

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a. [6:268] **Dealings with third persons:** Corporate officers are regarded by law as *agents* of the corporate entity in their dealings with third persons. The corporation is bound by such dealings, so long as they were "within the scope of the authority, *actual or apparent*, conferred by the board or within the agency power of the officer executing it …" [Corps.C. § 208(b) (emphasis added); *GAB Business Services, Inc. v. Lindsey & Newsom Claim Services, Inc.* (2000) 83 CA4th 409, 421, 99 CR2d 665, 673 (citing text) (disapproved on other grounds by *Reeves v. Hanlon* (2004) 33 C4th 1140, 1154, 17 CR3d 289, 299-300)]

(1) [6:269] **Actual authority:** Actual authority refers to powers conferred upon the officer, either expressly or impliedly, by the articles or bylaws, or by action of the board of directors. [Corps.C. § 208(b)]

("Actual authority" may also exist if the board "by want of ordinary care" allows an officer to believe they possess such authority; see Civ.C. § 2316.)

(a) [6:270] **Proof:** Whether actual authority has been conferred is a fact question in each case. The fact that the board of directors knows of the officer's acts and *does not object* thereto is evidence of actual authority. [See *Englert v. IVAC Corp.* (1979) 92 CA3d 178, 190, 154 CR 804, 810]

(2) [6:271] **Apparent authority:** Apparent authority exists where the corporation allows *third parties* reasonably to believe that the officer has the authority to act. In effect, the corporation is *estopped* to deny the officer's authority as to such third parties. [See Civ.C. §§ 2298, 2317]

(a) [6:272] **Requirements:** To establish "apparent authority," it must appear that:

- The third person *reasonably* believed that the officer had authority to act on behalf of the corporation; and

- Such belief was generated by *some act on behalf of the corporation* (such as allowing the officer to assume certain powers or functions on a continuing basis); and

- The third person was *not negligent* in relying upon the apparent authority so created. [*Associated Creditors' Agency v. Davis* (1975) 13 C3d 374, 399, 118 CR 772, 788]

(b) [6:273] **Application:** The president of a corporation who is running its business operations may be found to have ostensible authority to do "any act appropriate in the ordinary course of business." [*Englert v. IVAC Corp.* (1979) 92 CA3d 178, 190, 154 CR 804, 810—corporation barred from enforcing promissory note because its former president had given debtor extension of time to pay]

(3) [6:274] **Agency power of officers:** The corporation may also be bound by acts done "within the agency power of the officer …" [Corps.C. § 208(b)]

For example, a "Vice-President, in charge of Sales" would have "agency power" to enter into a sale of the corporation's products or services with a customer.

(a) [6:275] **Comment:** "Agency power" is really a form of apparent authority, ¶ 6:271.

(4) [6:276] **Compare—corporate instruments executed by certain officers:** Lack of authority can never be asserted by the corporation to avoid liability under written instruments executed by:

- The board chairperson or president or any vice president;

- *AND* the secretary or any assistant secretary or the chief financial officer or any assistant treasurer. [Corps.C. § 313; *Snukal v. Flightways Mfg., Inc.* (2000) 23 C4th 754, 784, 98 CR2d 1, 26 (citing text)]

Any contract, note, conveyance or other written instrument so executed is valid *despite the signing officers' lack of authority* … as long as the persons receiving such instruments had *no actual knowledge* thereof. [Corps.C. § 313; *Snukal v. Flightways Mfg., Inc.*, supra, 23 C4th at 783, 98 CR2d at 25; compare *Saks v. Charity Mission Baptist Church* (2001) 90 CA4th 1116, 1140-1142, 110 CR2d 45, 64-66—creditor knew note signed by corporate president was part of scheme to obtain personal benefit at corporate expense and hence creditor had actual knowledge of lack of authority]

(a) [6:276.1] **Signature of *two officers required:*** The Corps.C. § 313 "safe harbor" precluding the corporation from raising a "due authority" defense applies only to documents executed by at least *two corporate officers*—one from each of the two designated categories (¶ 6:276 ff.).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

However, where the same person holds two such offices (as permitted by Corps.C. § 312(a), *¶ 4:330*), the officer need not sign twice, and both offices need not be set forth on the executed document—i.e., § 313 "is satisfied when one individual who in fact holds two of the specified corporate offices executes the instrument" although signing only once and with only one of those offices identified on the instrument. [*Snukal v. Flightways Mfg., Inc.* (2000) 23 C4th 754, 786, 98 CR2d 1, 27-28 (citing text)—§ 313 barred corporation from denying authority of president/secretary to execute lease where signatory identified only as president]

b. [6:277] **Effect of limitations on officers' authority:** Limitations on the authority of corporate officers may be contained in the articles, bylaws, resolutions of the board of directors or even in shareholders agreements. (E.g., "No officer shall have authority to incur any obligation in the name of the corporation exceeding $5,000, without prior approval of the board of directors.")

(1) [6:278] **As against third persons:** Such limitations are usually of *no effect* against third persons dealing with the corporation (i.e., as long as the third person had no knowledge thereof, and believed the officer's acts were authorized, the corporation is usually bound). [Corps.C. § 208(a); *see ¶ 4:19*]

(2) [6:279] **As between officer and corporation:** On the other hand, an officer who exceeds their authority may be liable for any loss or damage caused thereby to the corporation. For example, if an officer made investments in violation of limitations contained in the articles (i.e., "ultra vires"), they may be liable to the corporation for resulting losses. (If the corporation failed to sue, a shareholder's derivative action would lie.) [Corps.C. § 208(a); see *Palm Springs Villas II Homeowners Ass'n, Inc. v. Parth* (2016) 248 CA4th 268, 281-283, 204 CR3d 507, 518-520]

4. [6:280] **Duties and Liabilities of Officers:** The duties and responsibilities of corporate officers are typically prescribed in the bylaws, or by resolution of the board of directors. [See Corps.C. §§ 300(a), 312(a)]

a. Duty of care

(1) [6:281] **No *statutory duty:*** Although it seems clear that corporate officers owe duties of care to the corporation, there is *no statute* prescribing what duty is owed, as there is with corporate directors (*¶ 6:244*).

(a) [6:281.1] **Exception—benefit corporations:** A statutory provision requires an officer of a benefit corporation, in certain circumstances, to act in accordance with interests and factors unique to benefit corporations. [Corps.C. § 14622, *¶ 9:556*]

The officer's failure to do so may be redressed by way of a benefit enforcement proceeding. [Corps.C. §§ 14601(b), 14623; *see ¶ 9:582 ff.*]

(2) [6:281.2] **Common law duty:** In the absence of statute, the degree of care turns on the officer's particular responsibilities in connection with the transaction in question.

(3) [6:281.3] **Liability not limited by articles:** Unlike directors, officers' personal liability for breaches of their duty of care may *not* be limited by the articles. This also applies to directors who are also officers, when acting as officers. [Corps.C. § 204(a)(10)(C); *¶ 6:250.1*]

b. [6:282] **Fiduciary duty of loyalty:** An officer who participates in corporate *management* by exercising *some discretionary authority* owes a fiduciary duty of *loyalty* to the corporation. This duty exists even where the officer's authority falls short of having *control* over the corporation. [*GAB Business Services, Inc. v. Lindsey & Newsom Claim Services, Inc.* (2000) 83 CA4th 409, 417-421, 99 CR2d 665, 670-673 (disapproved on other grounds by *Reeves v. Hanlon* (2004) 33 C4th 1140, 1154, 17 CR3d 289, 299-300)—officer who actively solicited other employees and used confidential information to set up competing business while still employed by corporation breached duty of loyalty; see *Bancroft-Whitney Co. v. Glen* (1966) 64 C2d 327, 345, 49 CR 825, 838-839 (same); *Angelica Textile Services, Inc. v. Park* (2013) 220 CA4th 495, 509, 163 CR3d 192, 204; *and ¶ 6:252*]

(1) [6:282.1] **Duty remains despite loss of authority:** An officer who is suddenly stripped of management power or discretion still owes a fiduciary duty to the corporation. To divest themselves of the duty, the officer must *resign* (or be removed) from office. [*GAB Business Services, Inc. v. Lindsey & Newsom Claim Services, Inc.* (2000) 83 CA4th 409, 421, 99 CR2d 665, 673 (disapproved on other grounds by *Reeves v. Hanlon* (2004) 33 C4th 1140, 1154, 17 CR3d 289, 299-300)]

(a) [6:282.2] **Rationale:** An officer who once enjoyed *actual* authority to bind the corporation in dealings with third parties is likely to retain *apparent* authority to do so as long as they remain an officer (*see ¶ 6:268 ff.*); such authority

should be restrained by an accompanying fiduciary duty. [*GAB Business Services, Inc. v. Lindsey & Newsom Claim Services, Inc.* (2000) 83 CA4th 409, 421, 99 CR2d 665, 673 (disapproved on other grounds by *Reeves v. Hanlon* (2004) 33 C4th 1140, 1154, 17 CR3d 289, 299-300)]

(2) [6:282.3] **Compare—"nominal" officer:** A person who has the title or designation of an officer but *no management authority* is *not* a fiduciary. Otherwise, a corporation could create a fiduciary duty of loyalty in any employee simply by giving them an officer's title. [*GAB Business Services, Inc. v. Lindsey & Newsom Claim Services, Inc.* (2000) 83 CA4th 409, 420, 99 CR2d 665, 672—whether officer had discretionary authority and hence duty of loyalty is question of *law* to be decided by court (disapproved on other grounds by *Reeves v. Hanlon* (2004) 33 C4th 1140, 1154, 17 CR3d 289, 299-300)]

(3) [6:282.4] **Compare—no duty of loyalty to warrant holders:** *See ¶ 6:345.2*.

(4) [6:283] ***Caution*—duty of loyalty (and care) owed by *all employees:*** *GAB Business Services*, supra, should not be read to imply that "nominal" or nonmanagerial officers, or employees who are not officers, are bereft of the duty of loyalty. *Every* employee owes the employer duties of "undivided care and loyalty" … regardless of their position or job status. [See *Janken v. GM Hughes Electronics* (1996) 46 CA4th 55, 74, 53 CR2d 741, 752; *Stokes v. Dole Nut Co.* (1995) 41 CA4th 285, 295, 48 CR2d 673, 681]

[6:283a - 6:283d] *Reserved.*

c. [6:283e] **False reports or accounting entries:** *See ¶ 6:253.1*.

d. [6:283.1] **Liability of corporate signatories:** Officers (and other agents) who execute contracts on behalf of the corporation may be held *personally liable* therefor if they are viewed as not having signed in a representative capacity … i.e., if:

• The *true name and corporate status* of the principal are not disclosed to the other party (a trade name is *not* sufficient); and

• Such party is not otherwise aware of the corporation's actual identity.

Rationale: Under agency law, agents are personally liable for contracts made on behalf of "partially disclosed" principals. [*G.W. Andersen Const. Co. v. Mars Sales* (1985) 164 CA3d 326, 332, 210 CR 409, 412—officer held personally liable for signing contract containing only corporation's trade name; see *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818, 238 CR3d 465, 472, fn. 7 (citing text)]

➪ [6:283.2] ***PRACTICE POINTER:*** Make sure that the signature blocks on all corporate *contracts, checks* and *promissory notes* contain the corporation's full *legal* name, and indicate that the signatory is signing as a representative of the corporation. Moreover, if the legal name does not indicate a corporate status (this is generally not required in California, *¶ 3:403*), be sure to do so; e.g., "XYZ, *a California corporation*, By: ___, Title: _____."

(1) [6:283.3] **Compare—personal liability not avoided by adding corporate title to signature:** On the other hand, simply adding an individual's corporate title to a signature on a contract that creates personal liability (e.g., a personal guaranty) will not relieve the signatory of liability. The title is considered merely descriptive of the *person*, *not* of the *relationship* in which they sign the agreement. [*Sebastian Int'l Inc. v. Peck* (1987) 195 CA3d 803, 809, 240 CR 911, 914—words "vice president" added to signature line of sublease guarantee did not relieve officer of personal liability; *Home Fed. Sav. & Loan Ass'n v. Ramos* (1991) 229 CA3d 1609, 1613, 284 CR 1, 3—officer not relieved of personal liability by adding word "Pres." to guarantee]

e. [6:283.4] **Liability for corporate torts:** Officers, like directors, do not incur personal liability for the corporation's torts *unless* they *participate* in the wrong or *authorize or direct* that it be done (*see ¶ 6:251.1 ff.*). [*Frances T. v. Village Green Owners Ass'n* (1986) 42 C3d 490, 507, 229 CR 456, 465; *Fleet v. Bank of America N.A.* (2014) 229 CA4th 1403, 1412, 178 CR3d 18, 26, fn. 9; *Balsam v. Trancos, Inc.* (2012) 203 CA4th 1083, 1108-1109, 138 CR3d 108, 127-128; see *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818, 238 CR3d 465, 472, fn. 7 (citing text)]

Personal liability may be based upon the officer's "tacit" consent—i.e., where the officer *concurs* in the tortious scheme with *knowledge* of its *unlawful purpose*. [See *Balsam v. Trancos, Inc.*, supra, 203 CA4th at 1109-1110, 138 CR3d at 128-129 (but finding no liability under the facts); *Schwartz v. Pillsbury Inc.* (9th Cir. 1992) 969 F2d 840, 843-844—liability may lie if corporate president knowingly supplied franchisees with offering circular containing misleading profitability information]

(1) [6:283.5] **Compare—real estate broker-officer not per se liable for failure to supervise corporate employee:** A corporation operating as a licensed real estate broker must designate a licensed *individual* broker as the officer responsible for supervision and control of the corporation's employees. [Bus. & Prof.C. §§ 10159.2(a), 10211; see 10 CCR § 2740]

The designated officer's statutory duty to supervise is owed to the *corporation*, and *not to third parties*. Thus, a third party injured by an employee's tortious conduct cannot invoke the officer's failure to supervise as a basis for liability against the officer. (But failure to supervise may be ground for regulatory discipline of the officer, and a corporation damaged by the officer's failure to supervise might have an indemnification action against them.) [*Sandler v. Sanchez* (2012) 206 CA4th 1431, 1434, 142 CR3d 771, 773; see more detailed discussion in Greenwald & Bank, *Cal. Prac. Guide: Real Property Transactions* (TRG), Ch. 2]

(2) [6:283.6] **Compare—licensed contractor-officer not per se liable for corporation's construction operations:** Similarly, a corporation operating as a licensed contractor must designate a licensed *individual* contractor as the managing officer (or employee) responsible for the corporation's construction operations. [Bus. & Prof.C. §§ 7068(b)(3), 7068.1]

Here again, the managing officer's statutory responsibility for the corporation's construction operations may subject the officer to regulatory discipline, but it does *not* render the officer liable for resulting injury to a *third party*. [*Swickheimer v. King* (1971) 22 CA3d 220, 224-225, 99 CR 176, 179]

f. Criminal liabilities

(1) [6:284] **Corporate reports:** Nondirector officers are subject to the same criminal liabilities as directors for fraudulent balance sheets, false reports, etc. [Corps.C. § 2254; ¶ *6:257 ff.*; see *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818, 238 CR3d 465, 472, fn. 7 (citing text)]

(2) [6:284a] **Concealed hazards:** Corporate officers and other management personnel of businesses subject to government regulation may be liable for serious concealed dangers of which they have actual knowledge, unless they abate the danger or give timely notice thereof to Cal-OSHA and all affected employees. [Pen.C. § 387 ("California Corporate Criminal Liability Act of 1989"); see *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818, 238 CR3d 465, 472, fn. 7 (citing text)]

This law is intended to hold accountable persons with actual authority for the safety of a product or business practice or facility, or for the conduct of research, testing and/or development of products.

Cross-refer: For more detailed discussion, *see* ¶ *6:597.6 ff.*

g. Liability for unpaid taxes

(1) [6:284.1] **Federal tax liability:** Officers (and other employees) who (a) are "responsible" for the corporation's payroll or financial affairs; and (b) have authority to disburse corporate funds, may be *personally liable* for willfully failing to collect and pay required federal taxes—e.g., federal withholding or employment taxes. The "responsible" employee bears the burden of proving the failure was not willful. [IRC § 6672; Treas.Reg. § 301.6672-1; *Oliver v. United States* (9th Cir. 1990) 921 F2d 916, 920; see *Lubetzky v. United States* (1st Cir. 2004) 393 F3d 76, 78, 80; see also *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818, 238 CR3d 465, 472, fn. 7 (citing text)]

(a) [6:284.1a] **Who is "responsible officer":** To be liable for failing to pay withholding taxes, the person must have *significant decision-making authority* over the corporation's *tax matters*—i.e., the "final word as to what bills should or should not be paid, and when." Thus, an officer's technical authority to sign payroll and other checks and duty to prepare tax returns are *not* enough to make them responsible where a superior (e.g., the president) has sole financial control and taxpaying authority. Conversely, a person who has ultimate authority over tax payments cannot escape liability by delegating the responsibility to another. [*Purcell v. United States* (9th Cir. 1993) 1 F3d 932, 936; *United States v. Jones* (9th Cir. 1994) 33 F3d 1137, 1139; *Alsheskie v. United States* (9th Cir. 1994) 31 F3d 837, 838; see also Internal Revenue Manual Administration ¶ 5.7.3.3 (Basis for Liability under IRC § 6672) re criteria used by IRS in determining whom to pursue under § 6672]

(b) [6:284.1b] **No "intent to defraud" or other bad motive required:** "Willfulness" requires only that the responsible person acted *voluntarily, consciously and intentionally* in not remitting the taxes to the government. Even conduct motivated by a reasonable cause may nonetheless be "willful." [*Davis v. United States* (9th Cir. 1992) 961 F2d 867, 871—responsible person who, after learning of tax deficiency, paid creditors instead of government acted willfully; see *Rykoff v. United States* (9th Cir. 1994) 40 F3d 305, 307; *Buffalow v. United States* (9th Cir. 1997) 109 F3d 570, 573]

1) [6:284.1c] **Gross negligence as "willfulness":** Ordinary negligence is not "willfulness." However, *gross negligence* or *recklessness* may constitute "willfulness," as where a responsible officer blindly delegates the taxpaying duty to an untrustworthy person who fails to pay the taxes. [*Phillips v. United States Internal Revenue Service* (9th Cir. 1996) 73 F3d 939, 943]

➪ [6:284.1d] ***PRACTICE POINTER:*** Be sure to warn corporate officers (and any other "down-line" employees) who have responsibility for the corporate payroll of their potential personal liability for unpaid taxes.

(c) [6:284.2] **100% penalty assessment:** In addition to the unpaid taxes, a "responsible person" may be assessed a penalty equal to the total amount of the unpaid taxes. (Ordinarily, the penalty is imposed following 60 days' written notice; but the IRS may dispense with prior notice if it deems collection of the penalty to be in jeopardy.) [IRC § 6672; see *Duncan v. Commr.* (9th Cir. 1995) 68 F3d 315, 317-318—penalty not tax deductible]

1) [6:284.2a] **Corporation's liability for penalties:** The corporation is *not* liable for statutory penalties if the failure to remit taxes is due to *reasonable cause and not due to willful neglect.* "Reasonable cause" may exist where the corporation was *disabled* from timely complying. [IRC §§ 6651(a), 6656(a); see *United States v. Boyle* (1985) 469 US 241, 248, 105 S.Ct. 687, 691, fn. 6]

Thus, where corporate funds, including those set aside for taxes, were *embezzled* by controlling corporate officers, penalties may be excused … unless the corporation itself was at fault (e.g., corporation failed to maintain adequate internal controls or secure competent independent auditors). To hold otherwise would punish innocent corporate stockholders (or creditors) who were no more responsible for the fraud than was the government. [See *In re American Biomaterials Corp.* (3rd Cir. 1992) 954 F2d 919, 927; and *Asphalt Indus., Inc. v. Commr*. (3rd Cir. 1967) 384 F2d 229, 233-234; compare *Conklin Brothers of Santa Rosa, Inc. v. United States* (9th Cir. 1993) 986 F2d 315, 318—corporation not "disabled" where failure to remit taxes resulted from conduct of subordinate and not controlling officers]

[6:284.2b - 6:284.2c] ***Reserved.***

(d) [6:284.2d] **Criminal liability:** A responsible person's failure to pay over required federal withholding or employment taxes is also punishable as a felony if the failure was "willful"—i.e., a voluntary, intentional violation of a known legal duty. "In other words, if you know that you owe taxes and you do not pay them, you have acted willfully." [See *United States v. Easterday* (9th Cir. 2009) 564 F3d 1004, 1009-1010—rejecting controlling shareholder's contention that lack of funds to pay over payroll taxes (because funds were spent to cover other business expenses) negated "willfulness"; IRC § 7202; *United States v. Thayer* (3rd Cir. 1999) 201 F3d 214, 219-220 (abrogation on other grounds recognized by *Fahie v. Virgin Islands* (3rd Cir. 2017) 858 F3d 162, 169)—"responsible person" under IRC § 7202 is same as under IRC § 6672]

(2) [6:284.2e] **State tax liability:** "Responsible" officers (and other individuals) may also be personally liable for a corporation's unpaid taxes owed under state law. For example:

(a) [6:284.2f] **Unemployment insurance contributions:** An officer, major stockholder or other person who has charge of a corporation's affairs and who *willfully fails* to pay required contributions to the State Unemployment Fund may be personally liable for the requisite amount, together with interest and any penalties thereon. [Unemp.Ins.C. § 1735]

(b) [6:284.2g] **Sales taxes:** Upon *termination*, *dissolution* or *abandonment* of a corporation, an officer or other person who had control or supervision of, or responsibility for, paying a corporation's sales and use taxes may be personally liable for any taxes (and interest and penalties) that they *willfully failed to pay*. *See ¶ 8:943*.

h. Liability under environmental laws

(1) [6:284.3] **CERCLA:** Under the Comprehensive Environmental Response, Compensation & Liability Act of 1980 (CERCLA, 42 USC § 9601 et seq.), corporate officers who have authority and control over the disposal of hazardous wastes can be held *personally liable* as "owners and operators" of any corporate facility from which the hazardous substances are released, and/or for arranging for their transportation and disposal. Such liability is based on the officer's *day-to-day management* and operation of the polluting facility. [See *Browning-Ferris Indus. of Ill., Inc. v. Ter Maat* (7th Cir. 1999) 195 F3d 953, 955-956; see also *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818, 238 CR3d 465, 472, fn. 7 (citing text); *and further discussion at ¶ 6:597.1 ff.*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [6:284.3a] **Underground storage tanks:** California law governing underground storage of hazardous substances (Health & Saf.C. § 25280 et seq.) imposes civil penalties of up to $5,000 per day on any "operator of an underground tank system" for violation of applicable State Water Resources Control Board regulations. [Health & Saf.C. § 25299(a)(6)]

Under the "responsible corporate officer" doctrine, an officer may be an "operator" and hence *personally* liable for the violation and resulting penalties where:

- The officer is in a position of responsibility that allows them to *influence corporate policies or activities*;
- There is a nexus between the officer's position and the violation such that the officer *could have influenced the corporate actions* that constituted the violations; and
- The officer's actions or inactions *facilitated* the violation. [*People v. Roscoe* (2008) 169 CA4th 829, 839, 87 CR3d 187, 195 (upholding penalties of almost $2.5 million against 2 officers/directors/shareholders of family company whose tank leaked gasoline into ground); see *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818, 238 CR3d 465, 472, fn. 7 (citing text)]

i. [6:284.4] **Liability under securities laws:** Officers may also incur personal liability for violations of federal or state securities laws. [See *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818, 238 CR3d 465, 472, fn. 7 (citing text)]

Some of the more significant provisions applicable specifically to officers are:

(1) [6:284.5] **Rule 10b-5 primary liability for signing SEC filing containing misrepresentations:** A corporate officer who, acting with scienter, signs a Form 10-K, 10-Q or other SEC filing containing material misrepresentations (or omissions) may be liable under SEC Rule 10b-5 (*¶ 6:360 ff.*) to investors who suffer losses by trading in reliance on the misrepresentations. The officer is deemed to have "*made*" the misrepresentations … even if they were contained in documents (e.g., financial statements) that the officer did not actually prepare, participate in or supervise. [*Howard v. Everex Systems, Inc.* (9th Cir. 2000) 228 F3d 1057, 1061-1063; *see ¶ 6:372.10*]

(a) [6:284.5a] **"Control person" (vicarious) liability:** *See ¶ 6:368.3 ff.*

(b) [6:284.5b] **Compare—Sarbanes-Oxley filing:** The mere signing of a Sarbanes-Oxley certification to an SEC periodic report is not itself sufficient to establish scienter for the purpose of the SEA § 21D(b) pleading standards (*see* ¶ 6:371.6 ff.). Rather, there must be additional facts showing recklessness in certifying the accuracy of the report or the financial statements contained therein. [*Glazer Capital Mgmt., LP v. Magistri* (9th Cir. 2008) 549 F3d 736, 747]

(2) [6:284.6] **Corps.C. § 25504 vicarious liability re offering fraud or failure to qualify:** Every *principal executive officer* and "every person occupying a similar status or performing similar functions" may be *vicariously* liable in damages for a corporation's violation of the Corps.C. § 25503 qualification requirements (*see ¶ 5:375*) or the Corps.C. § 25401 prohibitions on misrepresentations or fraud in connection with securities offerings or sales (*see ¶ 5:404*). [Corps.C. § 25504]

Additionally, every *employee* who "*materially aids*" in the violation may be vicariously liable. [Corps.C. § 25504; *see* ¶ *5:376, 5:405*]

(a) [6:284.7] **Lack of knowledge as defense:** Officers can avoid vicarious liability by showing they had no actual knowledge of the violation *and* were not aware of any suspicious circumstances. [Corps.C. § 25504; *see* ¶ *5:377, 5:407*]

(3) [6:284.8] **"Insider trading" liability:** *See ¶ 6:358 ff.*

(4) [6:284.9] **Executive compensation "clawback" for financial statement irregularities ("listed" companies):** *See ¶ 6:414.4a*.

[6:284.10] ***Reserved.***

j. Liability for unpaid employee compensation

(1) [6:284.11] **No personal liability under California statutes:** Corporate officers (or directors) are *not* personally liable under the California Labor Code for a corporate employer's failure to pay its employees contractual or statutorily-mandated wages, overtime compensation, vested vacation time and/or unreimbursed business expenses (see Lab.C. §§ 201-204, 210, 227.3, 510, 1194, 1194.2, 2802). This is so despite administrative pronouncements defining "employer" to include an individual who "exercises control" over employee wages, hours or working conditions (see 8 CCR §§ 11010(2)(F),

11040(2)(H), 11090(2)(F)): Imposing personal liability on officers for the corporation's statutory violations is not consistent with legislative intent as expressed throughout the Labor Code. [*Reynolds v. Bement* (2005) 36 C4th 1075, 1087-1088, 32 CR3d 483, 492 (employee class action for unpaid wages) (abrogated on other grounds by *Martinez v. Combs* (2010) 49 C4th 35, 63-66, 109 CR3d 514, 535-538); *Bradstreet v. Wong* (2008) 161 CA4th 1440, 1453, 75 CR3d 253, 263 (Labor Commissioner's action to collect unpaid wages on employees' behalf) (disapproved on other grounds by *ZB, N.A. v. Sup.Ct. (Lawson)* (2019) 8 C5th 175, 196, 252 CR3d 228, 243, fn. 8); *Jones v. Gregory* (2006) 137 CA4th 798, 802-809, 40 CR3d 581, 584-589 (same) (abrogated on other grounds by *Martinez v. Combs*, supra, and by *ZB, N.A. v. Sup.Ct. (Lawson*), supra)]

(a) [6:284.12] **No tort liability:** Nor does failure to comply with statutory overtime requirements itself constitute tortious conduct for which corporate officers (or directors) may be personally liable (*see ¶ 6:283.4*). [*Reynolds v. Bement* (2005) 36 C4th 1075, 1090, 32 CR3d 483, 494 (abrogated on other grounds by *Martinez v. Combs* (2010) 49 C4th 35, 63-66, 109 CR3d 514, 535-538)]

(b) [6:284.13] **Compare—civil penalties:** On the other hand, the Labor Code authorizes *civil penalties* against:

- "Any employer *or other person acting on behalf of an employer*" who causes *overtime* pay violations to occur. [Lab.C. § 558(a) (emphasis added); see *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818-826, 238 CR3d 465, 471-479—corporate director/president/secretary liable for § 558(a) penalties]

- "Any employer *or other person acting either individually or as an officer, agent or employee* of another person" for failure to pay *minimum* wages. [Lab.C. § 1197.1(a) (emphasis added); see *Atempa v. Pedrazzani*, supra, 27 CA5th at 818-826, 238 CR3d at 471-479—corporate director/president/secretary liable for § 1197.1(a) penalties]

- "[A]n employer *or other person acting on behalf of the employer*" who fails to reimburse an employee for business expenses incurred by the employee in the discharge of their duties. [Lab.C. § 2802 (emphasis added)]

And an employee awarded these civil penalties may also be awarded their attorney fees. [Lab.C. § 2699(g)(1); *Atempa v. Pedrazzani*, supra, 27 CA5th at 830-831, 238 CR3d at 482-483]

[6:284.14 - 6:284.15] ***Reserved.***

(2) [6:284.16] **Potential liability under federal law:** Under the Fair Labor Standards Act (FLSA, 29 USC § 201 et seq.), liability for unpaid employee compensation extends to any *individual or group of individuals* "acting directly or indirectly in the interest of an employer" in employment matters. [29 USC § 203(a),(d); see *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818, 238 CR3d 465, 472, fn. 7 (citing text)]

(a) [6:284.17] **Interaction of state and federal law:** The FLSA generally applies to employers and employees in industries engaged in, or producing goods for, interstate commerce. Although state law standards are usually more protective of employees than federal standards, California employers must comply with whichever standard provides *greater* protection to employees. [29 USC §§ 202(a), 218(a); *Aguilar v. Association for Retarded Citizens* (1991) 234 CA3d 21, 34-35, 285 CR 515, 523]

(b) [6:284.18] **"Economic reality" test:** Under an "economic reality" test that considers the "totality of the circumstances of the relationship," an officer or agent having an ownership interest in the corporation and *operational control of its business and payroll practices* may be deemed an FLSA "employer" and thus be jointly and severally liable along with the corporation for unpaid compensation. [*Dawson v. National Collegiate Athletic Ass'n* (9th Cir. 2019) 932 F3d 905, 909; *Boucher v. Shaw* (9th Cir. 2009) 572 F3d 1087, 1090-1094; *Department of Labor v. Cole Enterprises, Inc.* (6th Cir. 1995) 62 F3d 775, 778—50% shareholder's operational control over business supported finding that shareholder was "employer"; *De Guzman v. Parc Temple LLC* (CD CA 2008) 537 F.Supp.2d 1087, 1094—LLC president/secretary who owned 70% of facility and hired and determined plaintiff-employee's employment terms was "employer"]

Cross-refer: For a comprehensive discussion of potential personal liability for violations of these and other state and federal employment laws, see Chin, Wiseman, Callahan & Lowe, *Cal. Prac. Guide: Employment Litigation* (TRG).

k. [6:284.19] **Liability for deceptive marketing under Federal Trade Commission Act and related laws:** Corporate officers (and directors) may be personally liable for a corporation's fraudulent or deceptive marketing practices that violate the Federal Trade Commission Act (15 USC § 41 et seq.) and/or the Electronic Fund Transfer Act (15 USC § 1693). Individuals

may be liable if they *participated directly* in the violations or had *authority to control* the corporation and *knowledge* of its illegal activities. [See *Federal Trade Comm'n v. Commerce Planet, Inc.* (9th Cir. 2016) 815 F3d 593, 600 (abrogated on other grounds by *AMG Capital Mgmt., LLC v. Federal Trade Comm'n* (2021) 593 US 67, 75, 141 S.Ct. 1341, 1347); *Federal Trade Comm'n v. Grant Connect, LLC* (9th Cir. 2014) 763 F3d 1094, 1101-1102, 1104; *Federal Trade Comm'n v. Publishing Clearing House, Inc.* (9th Cir. 1997) 104 F3d 1168, 1170-1171; see also *Atempa v. Pedrazzani* (2018) 27 CA5th 809, 818, 238 CR3d 465, 472, fn. 7 (citing text)]

[6:284.20] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 6-E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

E. Conflict of Interest Limitations

- 1. [6:286] Interested-Director Transactions
  - a. What constitutes "interested-director" transaction
    - (1) [6:287] Contracts between director and corporation
    - (2) [6:288] Contracts with other company in which director has "material financial interest"
      - (a) [6:288.1] "Material financial interest"
  - b. [6:290] Requirements to avoid conflict-of-interest challenge
    - (1) [6:292] Shareholder approval after full disclosure
      - (a) [6:293] Full disclosure
      - (b) [6:294] Disinterested majority
        - 1) [6:294.1] Example
      - (c) [6:295] No showing of fairness required
    - (2) [6:296] Board approval after full disclosure, plus fairness
      - (a) [6:296.1] Full disclosure
      - (b) [6:296.2] Disinterested majority
        - 1) [6:296.2a] By written consent
          - a) [6:296.2b] "Interested" director abstention
            - 1/ [6:296.2c] Comment
      - (c) [6:296.3] Fairness requirement
    - (3) [6:297] Absent disinterested board or shareholder approval, fairness must be proved
      - (a) [6:297.1] Compare
      - (b) [6:297.2] Written consent action by "interested" board majority
      - (c) [6:297.3] Written consent action with director abstention
        - 1) [6:297.4] Deficient disclosures—action valid, but burden of proving fairness shifts
  - c. [6:298] Remedy to corporation
- 2. [6:299] Contracts Between Corporations With Interlocking Directorates
  - a. [6:301] Requirements to establish validity
    - (1) [6:302] Disclosure requirement
    - (2) [6:303] Approval requirement
      - (a) Disinterested board approval
        - 1) [6:304] At meeting
        - 2) [6:304.1] By written consent
          - a) [6:304.2] Common director abstention
            - 1/ [6:304.3] Action valid despite deficient disclosures

2/ [6:304.4] Comment
(b) [6:305] (Alternative) shareholder approval
(3) [6:307] Fairness requirement
(a) [6:309] Burden re fairness
b. [6:310] Remedy to corporations
3. [6:311] Acts Disadvantaging Corporation
a. [6:313] Corporate opportunities
(1) [6:314] What constitutes “corporate opportunity”
(2) [6:315] Factors considered
(a) [6:316] Corporate needs and plans
(b) [6:317] Corporation's ability to acquire
(c) [6:318] How opportunity discovered
(3) [6:319] Remedy
(4) [6:320] Compare—interested director contract
b. [6:322] Purchasing corporate obligations
(1) [6:323] Disputed claims
(2) [6:324] Purchasing obligations at discount
(a) [6:325] As corporate opportunity
(b) [6:326] Limitation—no unfair advantage over corporate creditors
c. [6:328] Competing with corporation
(1) [6:329] As unfair competition
(2) [6:333] Remedy to corporation
(3) [6:334] Compare—investing in competitor
4. [6:335] Controlling Shareholders
a. [6:336] Transactions between controlling shareholder and corporation
(1) [6:337] Disclosure and approval not sufficient
(2) Application
(a) [6:338] Purchasing corporate assets
(b) [6:339] Obtaining priority over other creditors
(c) [6:340] Converting stock to debt
(d) [6:341] Forcing repayment of shareholder loans
b. [6:342] Causing corporate action prejudicial to minority shareholders or creditors
(1) [6:343] Issuing shares in order to dilute minority interest
(2) [6:344] Dividend policy detrimental to minority
(3) [6:344.1] Elimination of preferred shareholders by sale of assets to related corporation
(4) [6:345] Placing corporation in bankruptcy to sell assets to creditor owned by majority shareholder
(5) [6:345.1] Transfer of professional corporation stock to unlicensed individual
(6) [6:345.2] Compare—no fiduciary duty to warrant holders
c. [6:346] Sale of controlling shares
(1) Application
(a) [6:347] Sale to “looter”
(b) [6:349] Sale to purchaser planning detrimental changes
(c) [6:350] Not allowing minority shares to participate in “going public”
(d) [6:350.1] Sale to corporation
(e) [6:351] Sale of shares accompanied by resignation of directors
(f) [6:352] Compare—simply obtaining premium for control
(2) [6:354] Remedy
(a) [6:355] Derivative suit for damage to corporation
(b) [6:356] Damages action by minority shareholders individually (or class action)

(c) [6:357] Compare—damages resulting from "freeze out"
(d) [6:357.5] No jury trial in breach of fiduciary duty action
5. [6:358] Insider Trading
a. [6:359] Federal securities laws
(1) [6:360] SEC Rule 10b-5
(a) [6:361] Broad scope of Rule
(b) [6:362] Interstate commerce requirement
1) [6:362.1] Limited transnational application
a) [6:362.2] Compare—foreign fraudulent conduct directed at U.S.
(c) [6:363] Persons liable under 10b-5
1) [6:364] Insiders ("classical theory")
a) [6:365] Noncorporate personnel as "temporary" insiders
b) [6:365.1] Providing inside information to "tippees" prohibited
2) [6:366] Tippees
a) [6:366.1] Tippee's derivative liability
b) [6:366.1a] Confidential information as "gift"
3) [6:366.2] Insiders liable to tippees
a) [6:366.3] Tippees ordinarily not subject to "in pari delicto" defense
b) [6:366.4] Effect
4) [6:367] "Outsider" liability ("misappropriation" theory)
a) [6:367.1] Example
1/ [6:367.1a] Comment
b) [6:367.1f] Breach of personal relationship (SEC Rule 10b5-2)
c) [6:367.2] Disclosure avoids liability
1/ [6:367.3] Compare—*state* law liability not vitiated by disclosure
2/ [6:367.4] Caution—disclosure to multiple sources
d) [6:368] "Misappropriation" theory limited to injunctive/criminal actions?
e) [6:368.1a] Compare—1988 Insider Trading and Securities Fraud Enforcement Act
f) [6:368.1b] Compare—Rule 14e-3 liability (tender offers)
g) [6:368.1c] Compare—mail and wire fraud liability
5) [6:368.2a] No liability where no breach of duty
6) [6:368.2j] Actual use of inside information *not* required ("knowing possession" standard)
a) [6:368.2k] Exception—trading pursuant to prior binding contract or plan
b) [6:368.2*l*] Exception—trading by employee of entity having established safeguards
c) [6:368.2m] California follows SEC Rule 10b5-1(c)
7) [6:368.3] Controlling persons
a) [6:368.3a] What constitutes "control"
b) [6:368.3b] "Vicarious control" liability
8) [6:368.3h] Federal government officials and employees
9) [6:368.3i] ERISA fiduciaries (ESOP administrators)
10) [6:368.4] No "aiding and abetting" liability
a) [6:368.5] Primary liability *not* affected
b) [6:368.6] No conspiracy liability
c) [6:368.7] Vicarious liability?
d) [6:368.8] Compare—SEC actions
(d) [6:368.9] Basic elements of Rule 10b-5 claim
1) [6:368.10] Heightened pleading requirements
a) [6:368.11] FRCP 9(b)
b) [6:368.12] Private Securities Litigation Reform Act (PSLRA)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(e) [6:369] Requirement of "materiality"
1) [6:369.1] "Materiality" although no immediate market reaction
2) [6:370a] When duty to disclose arises
a) [6:370b] Duty to update
b) [6:370c] Forecasts and opinions
1/ [6:370d] Mere risk of failure need not be disclosed
2/ [6:370e] "Safe harbor" for publicly-held companies
c) [6:370j] Matters of common knowledge
d) [6:370k] Third-party statements and forecasts
1/ [6:370*l*] Compare—misleading information deliberately supplied by company officials
2/ [6:370m] Accurate promotional statements—no duty to disclose payment by corporation
e) [6:370n] Materialized risks and contingencies
3) [6:370.1] "Materiality" of merger negotiations and other pending transactions
a) [6:370.2] Disclosure to outside shareholders
b) [6:370.3] Corporate repurchases from employees
c) [6:370.4] Compare—misleading statements
d) [6:370.5] Compare—silence
(f) [6:371] Scienter required
1) [6:371a] Negligence insufficient
2) [6:371.1] Recklessness may qualify
3) [6:371.2] Gross unfairness inadequate
4) [6:371.2a] Officer's scienter imputed to corporation; "adverse interest" exception inapplicable
5) [6:371.3] "Collective" or "imputed" scienter
6) [6:371.6] Pleading standards; "strong inference" test
a) [6:371.6a] General pleading rules apply
1/ [6:371.6b] Factual allegations accepted as true
2/ [6:371.6c] All facts considered
b) [6:371.6d] Plausible nonfraudulent explanations
1/ [6:371.6e] Application—statements about regulatory approval
c) [6:371.7] Compare—proving scienter at trial
d) [6:371.7a] Corporate documents prepared by multiple defendants—"group pleading" rejected
1/ [6:371.7b] Compare—"core operations" doctrine
e) [6:371.8] "Suspicious" insider trading as evidence of scienter
f) [6:371.9] Discovery stayed pending dismissal motion
(g) [6:372] Who may sue
1) [6:372.1] Aborted contract purchasers or sellers
a) [6:372.1a] Limitations
2) Forced sales
a) [6:372.2] Securities exchanged or sold due to mergers
1/ [6:372.2a] Compare—defendant's absolute power to force sale
b) [6:372.2b] Securities exchanged or altered in bankruptcy reorganization
3) [6:372.3] Pledges of securities
4) [6:372.3a] Trustee's acceptance of securities in lieu of cash
5) [6:372.3c] Shareholder suing for harm to corporation
6) [6:372.3d] Purchaser of stock in one corporation affected by fraud in another corporation

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

7) [6:372.4] Actions for injunctive relief
8) [6:372.4a] Compare—common law fraud actions
(h) [6:372.5] Reliance by plaintiff ("transaction causation")
1) [6:372.6] Nondisclosure cases
a) [6:372.6a] Compare—omissions *and* misrepresentations
2) [6:372.7] "Fraud on the market"
a) [6:372.7a] Limitation—"efficient market" prerequisite
b) [6:372.7b] No "fraud-on-the-market" presumption in California common law claims
c) [6:372.7c] Compare—"fraud-created-the-market"
d) [6:372.7d] Loss causation distinguished
e) [6:372.7e] Relevance of generic statements
3) [6:372.7h] "Reliance on regulatory process"
4) [6:372.7j] Presumption may be rebutted
a) [6:372.7p] Defendants bear burden of persuasion
5) [6:372.7t] Compare—reliance thwarted by "nonreliance clause" in stock purchase contract
6) [6:372.7u] Compare—reliance not required in SEC injunctive action
(i) [6:372.8] "In connection with" requirement
1) Application
2) [6:372.8g] Product advertisements
3) [6:372.9] Fraud must be causally related to purchase or sale
4) [6:372.10] Defendant need not purchase or sell securities
(j) [6:373] Private remedies
1) [6:373a] Insider trading liability limited to "contemporaneous" traders
2) [6:373d] Loss causation requirement
a) [6:373e] Loss causation as proximate cause
b) [6:373f] Corrective disclosures; loss causation in "fraud-on-the-market" cases
1/ [6:373g] "Corrective disclosure" defined
2/ [6:373h] Corrective disclosures can come from any source
3/ [6:373i] Partial corrective disclosures
4/ [6:373j] Corrective disclosures need not be precise
5/ [6:373k] Publicly available sources; Freedom of Information Act (FOIA) requests
6/ [6:373*l*] Application in "fraud-on-the-market" cases; proving "inflated" purchase prices
7/ [6:373m] "Inflation-maintenance" likewise actionable
c) [6:373n] Proof of damages distinguished
d) [6:373*o*] Rescissionary damages available
e) [6:373p] Heightened pleading requirements apply
f) [6:373u] Proof of loss causation not required to obtain class certification
3) [6:373.1] Statutory damages cap
a) [6:373.2] Equitable limits on recovery
1/ [6:373.2a] No disgorgement of profits due to special efforts
b) [6:373.2b] Other measures of compensatory damages?
1/ [6:373.2c] Compare—SA § 11 actions
c) [6:373.3] Offset for tax benefits?
d) [6:373.3a] Injunctive relief to protect potential damages remedy?
4) [6:373.3b] Attorney fees and costs; FRCP 11 sanctions
a) [6:373.3c] Attorney fees and costs as presumptively proper sanction
5) [6:373.4] No punitive damages

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

6) [6:374a] Apportionment of liability
a) [6:374b] Additional responsibility if judgment uncollectible
b) [6:374c] Contribution among defendants
c) [6:374d] Settling defendant's discharge from contribution
d) [6:374h] Indemnification
e) [6:374i] Statute of limitations
7) [6:374j] Arbitration
(k) [6:374.1] SEC action for treble damages
1) [6:374.1a] Controlling persons' liability
2) [6:374.1b] Aiders' and abettors' liability
a) [6:374.1c] SEC's burden of proof
3) [6:374.2] Applies only to exchange trades
4) [6:374.3] Not available in private actions
5) [6:374.4] Compare—civil penalties and injunctions
a) [6:374.5] Right to jury trial
b) [6:374.6] Not available in insider trading cases
(l). [6:375] Two-year/five-year statute of limitations
1) Accrual of action
a) [6:375.2c] Two-year statute accrues upon discovery of fraud
1/ [6:375.2d] Caveat re “inquiry notice”
2/ [6:375.2e] Effect of equitable tolling on class action
b) [6:375.2f] Five-year statute accrues upon *sale of securities*
c) [6:375.2g] Contribution actions
2) [6:375.2i] Analogous two-year/five-year statute for California actions
3) [6:375.3] Compare—five-year limitations period under Insider Trading and Securities Fraud Enforcement Act of 1988
4) [6:375.3a] Compare—five-year limitations period on SEC civil penalty action
(m) [6:375.4] Procedural matters
(n) [6:375.5] Preclusion (“preemption”) of state securities fraud actions (SLUSA)
1) [6:375.6] “Covered securities”
2) [6:375.7] “Covered class actions”
3) [6:375.8] “In connection with”
a) [6:375.8a] No “purchase/sale” requirement
b) Application
4) [6:375.9] Nonsecurities actions sounding in securities fraud likewise precluded
5) [6:375.10] Certain actions *not* precluded
6) [6:375.14] Preclusion as jurisdictional
(o) [6:375.15] Res judicata and collateral estoppel
(2) [6:376] Section 16
(a) [6:377] Applies only to registered securities
1) [6:377.1] Not applicable to foreign private issuers
(b) [6:378] Reporting requirement
1) [6:378.1] Corporation's obligation to disclose noncompliance
(c) [6:379] “Short-swing” profits belong to corporation
1) [6:379.1] “Officers” subject to § 16(b)
2) [6:379.1a] “More than 10% shareholders”—initial purchase not counted
3) [6:379.1b] Shareholder group owning more than 10%
4) [6:379.2] Voluntary exchange of securities constitutes § 16(b) sale
5) [6:379.2a] Dividends ordinarily excluded from “profit”

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

6) [6:379.2e] Exemption for certain issuer transactions approved by directors or shareholders
7) [6:379.3] Exemption for securities acquired as collateral for debt
8) [6:379.4] Multiple acquisitions by shareholder—"tainted" shares deemed sold
(d) [6:380.6] Two-year statute of limitations
1) [6:380.7] No automatic tolling for failure to file § 16 report
(e) [6:381] Compare—Rule 10b-5
b. [6:382] California Corporate Securities Law
(1) [6:383] "Insider" defined
(a) [6:384] Tippees, etc.?
(b) [6:385] Comment
(c) [6:385.5] No "misappropriation" liability
(2) [6:386] Who may recover
(3) [6:387] Privity required
(4) [6:387.5] Exception for trades pursuant to prior contract or plan or by entity having established safeguards
(5) [6:388] Relief available
(a) [6:388.1] Treble damages for public corporation
1) [6:388.2] Purpose
2) [6:388.3] Set-offs
3) [6:388.4] Derivative action to enforce
4) [6:388.5] Applicable to foreign corporation insiders
(b) [6:389] Compare—rescission
(c) [6:389.1] Compare—criminal penalties
c. [6:390] Common law liability

[6:285] Directors, officers and controlling shareholders are required to act with "inherent fairness" to the corporation and those interested therein. [*Jones v. H.F. Ahmanson & Co.* (1969) 1 C3d 93, 110, 81 CR 592, 600; see *Steinberg v. Amplica, Inc.* (1986) 42 C3d 1198, 1210, 233 CR 249, 256; see also *Meister v. Mensinger* (2014) 230 CA4th 381, 395, 178 CR3d 604, 615]

This "fairness" requirement underlies various statutory and common law limits on conflict-of-interest transactions: i.e., transactions in which the personal interests of such directors, officers or controlling shareholders *may* conflict with those of the corporation:

1. [6:286] **Interested-Director Transactions:** As long as the requirements below are met (¶ *6:290 ff.*), a contract or other transaction between a director and the corporation is "neither void nor voidable" because of the director's interest therein. (In contrast, if those requirements are *not* met, the transaction will be upheld only if the director can *prove* its "fairness" to the corporation.) [Corps.C. § 310(a)(3), (b)(2)]

a. What constitutes "interested-director" transaction

(1) [6:287] **Contracts between director and corporation:** ANY contract or transaction directly between the corporation and one or more of its directors is subject to the requirements below (¶ 6:290 ff.). The "materiality" of the director's interest is presumed. [Corps.C. § 310(a)]

Typically, this includes compensation arrangements, stock option agreements, buying or selling assets, leasing property, etc.

(2) [6:288] **Contracts with other company in which director has "material financial interest":** A contract or other transaction with another firm (corporation, partnership or other business entity) is also subject to the requirements below (¶ 6:290 ff.) if a director has "a material financial interest" in such firm. [Corps.C. § 310(a)]

(a) [6:288.1] **"Material financial interest":** "Material financial interest" is not defined, but the statute specifically *excludes* "mere common directorships" and reciprocal voting for directors' and officers' compensation (Corps.C. § 310(a), last sentence; *see*¶ *6:431*). The matter is left to case-by-case determination in the courts.

➪ [6:289] ***PRACTICE POINTER:*** If there is the slightest doubt as to whether a particular interest is subject to Corps.C. § 310, by all means follow the procedures below (¶ 6:290 ff.). This will insulate the transaction and the approving directors from any challenge on grounds of conflict of interest.

b. [6:290] **Requirements to avoid conflict-of-interest challenge:** Contracts between a corporation and one of its directors are "*neither void nor voidable*" because of the director's self-interest in the transaction, if the statutory procedures below (¶ 6:292 ff.) are followed. [Corps.C. § 310]

Compliance with these procedures insulates the transaction from challenge *on the ground of the director's self-interest*. (But it may still be subject to challenge on other grounds—e.g., breach of fiduciary duty by the board, "waste" of corporate assets, etc.; *see*¶ *6:421*.)

[6:291] ***Reserved.***

(1) [6:292] **Shareholder approval after full disclosure:** A contract cannot be challenged because of a director's financial interest if the *material facts* were disclosed to the shareholders, and the contract was thereafter approved by a majority of the disinterested shares. [Corps.C. § 310(a)(1)]

(a) [6:293] **Full disclosure:** All material facts, both as to the director's interest in the transaction, and as to the contract itself, must be disclosed to (or already known by) the shareholders. [Corps.C. § 310(a)(1)]

(b) [6:294] **Disinterested majority:** Any shares held by the "interested" director are not entitled to vote. The transaction must be approved by a majority of disinterested shareholders, acting in good faith. [Corps.C. § 310(a)(1)] (Shareholder approval means a majority of the shares—*excluding all interested shares*—present and voting at a meeting, or written consents executed by a majority of the shares entitled to vote; see Corps.C. § 153, ¶ *6:8*.)

1) [6:294.1] **Example:** 1000 shares are issued and outstanding. Director X owns 600 shares and has an interest in the transaction. The required quorum for shareholder action on this interested-director transaction is 201 shares—a majority of the 400 disinterested shares entitled to vote. (This is so by reason of Corps.C. § 112, which states that whenever shares are disqualified from voting on any matter, they are not to be considered outstanding "for the determination of a quorum at any meeting to act upon, or the required vote to approve action upon, that matter".) A majority of the disinterested shares present and voting is required to approve the transaction (a minimum of 101 votes—the majority of a bare quorum) to avoid a potential challenge on the ground of director self-interest.

(c) [6:295] **No showing of fairness required:** If such shareholder approval is obtained, the contract need *not* be shown to be "just and reasonable" to the corporation—as it must be without such approval (¶ 6:296 ff.).

(2) [6:296] **Board approval after full disclosure, plus fairness:** Nor can a contract be challenged because of a director's self-interest in the transaction if the *material facts* were disclosed to the board, and it was thereafter approved by a *disinterested majority* of the directors, *and* the contract was "*just and reasonable* as to the corporation" at the time it was authorized, approved or ratified. [Corps.C. § 310(a)(2)]

(a) [6:296.1] **Full disclosure:** Again, all material facts regarding the director's interest, and the contract itself, must be disclosed or known to the board before acting upon the matter. [Corps.C. § 310(a)(2)]

(b) [6:296.2] **Disinterested majority:** The "interested" director's vote cannot be counted to make up the board majority. The board vote must be sufficient to authorize the transaction *excluding* the interested director. (But such director may be present at the meeting which votes on the contract; and may also be counted as part of the quorum for such meeting; see Corps.C. § 310(c), ¶ *6:222 ff.*)

1) [6:296.2a] **By written consent:** Since *any* "action required or permitted to be taken by the board may be taken without a meeting" by unanimous written consent (Corps.C. § 307(b) (emphasis added), ¶ *6:233 ff.*), the sterilizing approval by a "disinterested majority" of the directors may be given in an action by *unanimous written consent* … so long as the material facts are fully disclosed to the disinterested majority of directors. [Corps.C. §§ 194, 310(a)(2)]

a) [6:296.2b] **"Interested" director abstention:** Where the "interested" director (or directors) abstains in writing, the written consent of the remaining directors is nevertheless deemed a "unanimous" written consent so long as:

- The disclosures required by Corps.C. § 310 (¶ *6:296.1*) are made to the remaining directors *before* they execute the consent;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The specified disclosures are "conspicuously included" in the consent executed by the remaining directors; *and*

• *All* the remaining directors approve the action, and their approval constitutes a sufficient "vote" without counting the "interested" director (or directors). [Corps.C. § 307(b)]

1/ [6:296.2c] **Comment:**Corps.C. § 307(b) was amended in 2005 to provide an *alternative* to the normal written consent procedure and thus allow the board the convenience of acting by written consent while simultaneously accommodating those directors who did not feel comfortable approving a transaction in which they had a material interest. Accordingly, there are more procedural requirements for a written consent where the "interested" directors abstain.

➪ [6:296.2d] ***PRACTICE POINTER:*** Even where no directors abstain, the required disclosure should be "on the record"—i.e., set forth in the unanimous written consent itself or, alternatively, on a disclosure statement attached to and incorporated by a conspicuous reference in the written consent.

(c) [6:296.3] **Fairness requirement:** Where only board approval (and not shareholder approval) has been obtained, the transaction must also be "just and reasonable to the corporation" at the time of such approval.

But disinterested board approval effectively raises a presumption of fairness to the corporation, so that the burden of proving its *lack* of fairness is on the party challenging the contract (e.g., either a shareholder in a derivative action, or the corporation itself).

(3) [6:297] **Absent disinterested board or shareholder approval, fairness must be proved:** Failure to obtain disinterested board or shareholder approval does not necessarily render an interested director contract void. However, in such cases, the burden rests on the party seeking to *uphold* the contract (normally, the "interested" director) to prove that it was "just and reasonable" to the corporation at the time it was authorized or entered into. [Corps.C. § 310(a)(3); *Sammis v. Stafford* (1996) 48 CA4th 1935, 1943, 56 CR2d 589, 594 (quoting text)—corporation's employment contracts with president/director and his wife/director valid despite approval by interested majority (contracts found "fair"); *Walczak v. EPL Prolong, Inc.* (9th Cir. 1999) 198 F3d 725, 732]

(a) [6:297.1] **Compare:** As stated above (¶ 6:292), where *shareholder approval* is obtained, no separate showing of "fairness" is required. And, where *board approval* (rather than shareholder approval) has been obtained, there is in effect a presumption of fairness, so that the burden of proving lack of fairness is on the party challenging the contract. But, absent either board or shareholder approval, the burden rests squarely on the party seeking to enforce the contract to prove its fairness to the corporation. (*See*¶ *6:434*.)

(b) [6:297.2] **Written consent action by "interested" board majority:** Where the corporate action is authorized by unanimous written consent and a majority of the directors are "interested" (i.e., the action is *not* sterilized by approval of a *disinterested majority*, ¶ *6:296.2a*), the action is nevertheless valid. However, as in the case of an "interested director" voting on a transaction (¶ *6:223.2 ff.*), if the transaction is later challenged, it will be set aside unless the interested directors (or others asserting the validity of the transaction) can prove it was "just and reasonable" to the corporation. [Corps.C. § 310(a)(3)]

(c) [6:297.3] **Written consent action with director abstention:** Special provisions apply where the directors "unanimously" approve the transaction by written consent but one or more directors abstain in writing.

1) [6:297.4] **Deficient disclosures—action valid, but burden of proving fairness shifts:** If the "interested" directors' *disclosures* did *not* comply with Corps.C. § 310 (but the consent satisfied all the other conditions of § 307(b), *see*¶ *6:296.2b*), the action is nevertheless deemed approved; however, in any suit brought to challenge the action, the party asserting the validity of the action has the burden of proving the action was "just and reasonable to the corporation" at the time of approval. [Corps.C. § 307(b)]

➪ [6:297.5] ***PRACTICE POINTER:*** Cautious counsel should advise the directors to *comply fully* with the literal requirements of the Corps.C. § 307(b) provisions pertaining to written consents where "interested" directors abstain (¶ *6:296.2b*).

c. [6:298] **Remedy to corporation:** If the contract or transaction fails to meet the above requirements (¶ 6:290 ff.), various remedies are available to the corporation. It may either:

• *Rescind* the contract and recover anything of value paid to the director; or

• Affirm the contract and sue for *damages* (the amount of the "unfairness" or excessive price charged to the corporation). [See *Remillard Brick Co. v. Remillard-Dandini Co.* (1952) 109 CA2d 405, 421-422, 241 P2d 66, 76]
(If the corporation fails or refuses to bring an action against the director, a derivative suit may be maintained on its behalf by any shareholder; *see*¶ *6:602 ff.*)

2. [6:299] **Contracts Between Corporations With Interlocking Directorates:** Conflicts of interest may arise where the same person or persons sit as directors of several corporations dealing with each other. A mere common directorship does *not* constitute a "material financial interest" of the individual directors in either corporation (Corps.C. § 310(a)). However, the situation poses a potential conflict of interest because the directors' duties of *loyalty* to each corporation makes it incumbent upon them to seek the best possible deal for each.

➪ [6:300] ***PRACTICE POINTER:*** Watch out for this problem with parent-subsidiary corporations in which the boards are composed of substantially the same people. There won't be anyone to object, of course, if the parent owns 100% of the stock of the subsidiary. But where there are minority shareholders in the subsidiary, they may feel that the parent corporation is taking advantage of the subsidiary through dominating its board. If the requirements below (¶ 6:301 ff.) are not respected, the parent-subsidiary dealings are vulnerable to attack.

a. [6:301] **Requirements to establish validity:** If the following requirements are met, intercorporate contracts cannot be challenged because of such common directorships:

(1) [6:302] **Disclosure requirement:** The "material facts of the transaction," including the fact of the common directorships, must be disclosed or known to the boards of each corporation; or to the shareholders where their approval is sought (¶ 6:303). [Corps.C. §§ 307(b), 310(b)(1)]

(2) [6:303] **Approval requirement:** After such disclosure, the intercorporate contract may be approved *either* by the board *or* shareholders of each corporation:

(a) Disinterested board approval

1) [6:304] **At meeting:** The common directors' votes cannot be counted as part of the majority vote required at a meeting to authorize, approve or ratify the contract. [Corps.C. § 310(b)]
But they may be present at the meeting, and may be counted as part of the quorum required for the meeting. [Corps.C. § 310(c)]

2) [6:304.1] **By written consent:** Since *any* "action required or permitted to be taken by the board may be taken without a meeting" by unanimous written consent (Corps.C. § 307(b) (emphasis added), ¶ *6:233 ff.*), the approval may be given in an action by unanimous written consent. Here again, however, the common directors' consents cannot be counted as part of the majority necessary to authorize, approve or ratify the contract. [Corps.C. §§ 307(b), 310(b)]

a) [6:304.2] **Common director abstention:** Where the common director (or directors) abstains in writing, the written consent of the remaining directors is nevertheless deemed a "unanimous" written consent so long as:

• The disclosures required by Corps.C. § 310 (¶ *6:296.1*) are made to the remaining directors *before* they execute the consent;

• The specified disclosures are "conspicuously included" in the consent executed by the remaining directors (or on a disclosure statement attached to and incorporated by a conspicuous reference in the written consent); *and*

• *All* the remaining directors approve the action, and their approval constitutes a sufficient "vote" without counting the common director (or directors). [Corps.C. § 307(b)]

1/ [6:304.3] **Action valid despite deficient disclosures:** If the disclosures did *not* comply with Corps.C. § 310 (but the consent satisfied all the other conditions of § 307(b), ¶ *6:304.2*), the action is nevertheless deemed approved; however, in any suit brought to challenge the action, the party asserting the validity of the action has the burden of proving the action was "just and reasonable to the corporation" at the time of approval. [Corps.C. § 307(b)]

2/ [6:304.4] **Comment:** Corps.C. § 307(b) was amended in 2005 to provide an *alternative* to the normal written consent procedure and thus allow the board the convenience of acting by written consent while simultaneously accommodating any common directors who did not feel comfortable approving a transaction in which they had an ostensible conflict of interest. Accordingly, there are more procedural requirements for a written consent where the common directors abstain.

(b) [6:305] **(Alternative) shareholder approval:** Shareholder approval may be obtained by vote of a majority of the shares represented and voting at a shareholders' meeting, or written consents executed by a majority of the voting shares, provided such approval is "in good faith." [Corps.C. § 310(b)(1)]

[6:306] Note that the common directors are not disqualified from voting shares they own … *unless* they own so many that it would be deemed an "interested-director" transaction (¶ 6:287 ff.) requiring approval by a disinterested majority of shares (*¶ 6:294*).

(3) [6:307] **Fairness requirement:** Unlike "interested-director" transactions (*¶ 6:286 ff.*), there is no additional requirement that the interlocking-directorate transaction be "just and reasonable" to each corporation. *Absent approval by the board or shareholders*, fairness becomes a separate requirement: i.e., transactions between corporations with common directors may still be upheld if the transaction is "just and reasonable as to the corporation at the time it is authorized, approved or ratified." [Corps.C. § 310(b)(2)]

[6:308] ***Reserved.***

(a) [6:309] **Burden re fairness:** Unlike Corps.C. § 310(a)(3), which imposes the burden of establishing that an interested director transaction was "just and reasonable" upon the person asserting the validity of the transaction (*¶ 6:297*), Corps.C. § 310(b)(2) is silent on who bears the burden of establishing that a contract between corporations with interlocking directors is "just and reasonable" absent disinterested board approval. Presumably, the burden is on the party attacking the transaction to establish its lack of fairness. However, in such circumstances, the burden should not be heavy: Establishing minimal facts to raise questions about the fairness of the transaction should *shift* the burden to the contract *parties* to establish the reasonableness of the transaction at the time it was approved by the respective parties' boards.

b. [6:310] **Remedy to corporations:** Absent compliance with the above requirements (¶ 6:301 ff.), inter-corporate transactions may be voidable by either corporation.

If either fails to bring an action to set it aside, a derivative action can be maintained on its behalf by a shareholder of either corporation (*see* *¶ 6:602 ff.*).

3. [6:311] **Acts Disadvantaging Corporation:** Directors and officers owe a fiduciary duty of loyalty to the corporations they serve (*¶ 6:252*). This duty of loyalty obligates corporate officers and directors not to "overreach" or take advantage of the corporation. It also obligates them to avoid dealings in which their own personal interests may conflict with those of the corporation, and thus color the sound judgment which they owe to the corporation.

"[P]ublic policy … has established a rule that demands of a corporate officer or director … the most scrupulous observance of his duty … to *refrain* from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers." [*Bancroft-Whitney Co. v. Glen* (1966) 64 C2d 327, 345, 49 CR 825, 838-839, citing *Guth v. Loft, Inc.* (Del.Ch. 1939) 5 A2d 503, 510 (emphasis added; internal quotes omitted)]

[6:312] ***Reserved.***

a. [6:313] **Corporate opportunities:** Directors or officers may not seize a corporate opportunity for themselves without first offering it to the corporation on the same terms as available to them. In effect, they owe a *right of first refusal* to the corporation as to any such "opportunity." [*Industrial Indemnity Co. v. Golden State Co.* (1953) 117 CA2d 519, 533, 256 P2d 677, 686]

(1) [6:314] **What constitutes "corporate opportunity":** Each case turns on its own facts, but the basic question is whether the opportunity is so closely related to the business of the corporation that it would be *unfair* for the director or officer to take advantage of it personally. [*Industrial Indemnity Co. v. Golden State Co.* (1953) 117 CA2d 519, 533, 256 P2d 677, 686; see *Kelegian v. Mgrdichian* (1995) 33 CA4th 982, 988-989, 39 CR2d 390, 394; and *Robinson, Leatham & Nelson, Inc. v. Nelson* (9th Cir. 1997) 109 F3d 1388, 1392-1393]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [6:315] **Factors considered:** The following factors are usually important in deciding whether the opportunity belongs to the corporation:

(a) [6:316] **Corporate needs and plans:** Whether the corporation *would* have taken the opportunity: Is it in the corporation's "line of business" or does the corporation have a *tangible* interest or expectancy in the opportunity; i.e., a present need or expansion plans which involve the property or business opportunity (as opposed to a mere possibility of interest therein)? [See *Kelegian v. Mgrdichian* (1995) 33 CA4th 982, 990-991, 39 CR2d 390, 394-395—director's share purchases did not usurp corporate opportunity absent corporation's plan or policy to reacquire its own shares; see also *Robinson, Leatham & Nelson, Inc. v. Nelson* (9th Cir. 1997) 109 F3d 1388, 1394]

(b) [6:317] **Corporation's ability to acquire:** Whether the corporation *could* have taken the opportunity: i.e., did the corporation have the funds or resources available, in capital or through borrowing, to take advantage of the opportunity? [See *Kelegian v. Mgrdichian* (1995) 33 CA4th 982, 990, 39 CR2d 390, 395; *Robinson, Leatham & Nelson, Inc. v. Nelson* (9th Cir. 1997) 109 F3d 1388, 1394]

(However, an out-of-state case held that a corporation's claimed financial inability was irrelevant where a co-shareholder-director diverted and *concealed* the opportunity without giving the corporation a chance at it; see *Klinicki v. Lundgren* (OR 1985) 695 P2d 906, 920.)

(c) [6:318] **How opportunity discovered:** Whether the business or opportunity was discovered by the director or officer in his capacity as such, or he came upon it accidentally while acting on his own behalf (and whether any corporate funds were expended in discovering such property or opportunity). [See *Industrial Indemnity Co. v. Golden State Co.* (1953) 117 CA2d 519, 533, 256 P2d 677, 686 (citing *Guth v. Loft, Inc*. (Del. 1939) 23 Del.Ch. 255, 5 A2d 503); *Robinson, Leatham & Nelson, Inc. v. Nelson* (9th Cir. 1997) 109 F3d 1388, 1394]

➪ [6:318.1] ***PRACTICE POINTER:*** If there is any doubt, directors and officers should always present a corporate opportunity to the board before seizing it themselves. A declination (or failure to act) by a disinterested board will avoid any later claims of usurpation should the opportunity prove profitable. (Usurpation claims are never made on unprofitable deals.)

(3) [6:319] **Remedy:** If a director or officer fails to offer a "corporate opportunity" to the corporation, and instead purchases it himself, the corporation can sue to impose a *constructive trust* on the property—i.e., the director or officer may be forced to convey the property to the corporation at his cost, and to account to the corporation for net rents, issues or profits obtained from the property while he held it. (If already sold, the director or officer will be forced to disgorge whatever profits were made on the resale.) [See *Industrial Indemnity Co. v. Golden State Co.* (1953) 117 CA2d 519, 533, 256 P2d 677, 686; *Brophy v. Cities Service Co.* (Del.Ch. 1949) 70 A2d 5, 8 ("Public policy will not permit an employee occupying a position of trust and confidence toward his employer to abuse that relation to his own profit, regardless of whether his employer suffers a loss")]

(Again, if the corporation fails or refuses to sue, a derivative action may be maintained on its behalf by any shareholder of the corporation; *see*¶ *6:602 ff.*)

(4) [6:320] **Compare—interested director contract:** Sometimes, "corporate opportunity" and "interested director" issues are involved in the same transaction: For example, suppose Director purchases property next door to his corporation's factory for $100,000. Later, he sells the property to the corporation for $200,000, although its fair market value is no more than $150,000.

• If the property acquisition is held to be a "corporate opportunity," the corporation is entitled to it at Director's *cost* ($100,000), together with any rents or profits received by the director in the interim.

• If not a "corporate opportunity," the corporation's right to damages or rescission depends on the disclosure, approval and fairness requirements for interested director contracts (¶ *6:286 ff.*). At a minimum, the damages will be the unfair profit made by Director on the sale ($50,000).

➪ [6:321] ***PRACTICE POINTER:*** This is a frequent problem area, because many officers and directors simply do not realize the impact of their fiduciary duties to the corporation.

Be sure to "educate" them. *Upon assuming office*, corporate officers and directors should be told that if there is *any reason to believe* the corporation would be interested in purchasing any property or taking any "deal" they are considering for themselves, they may owe a duty to bring the deal to the attention of senior officers (or the board

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

itself) *before* consummating the transaction. If they fail to do so, they may be exposed to later claims of usurping a corporate opportunity.

b. [6:322] **Purchasing corporate obligations:** Normally, there is no problem with directors or officers also being creditors of their corporation. They may either loan their own funds directly to the corporation, or purchase its bonds, notes or other obligations from others.

But there are circumstances in which it would be "inequitable" for directors or officers to purchase or enforce claims against the corporation:

(1) [6:323] **Disputed claims:** There is an inherent conflict of interest when a director or officer purchases a claim that is *unliquidated* or that is *disputed* by the corporation. The independent judgment and loyalty owed by such director or officer to the corporation may be impaired by their personal financial interest in enforcing such a claim. The corporation's remedy may be to sue to impose a constructive trust upon the disputed claim. [See Anno. 13 ALR2d 1171]

(2) [6:324] **Purchasing obligations at discount:** There may also be a conflict of interest where a director or officer purchases the corporation's bonds or notes at a *discount*, and later seeks to enforce payment at face value.

(a) [6:325] **As corporate opportunity:** If the corporation was solvent and had funds which could have been used for the purchase, the opportunity to buy its bonds at a discount may be treated as a "corporate opportunity."

In contrast, if the corporation was *financially unable* to buy its obligations at the price offered, it cannot object if a director or officer purchases them. Nor can it force such director or officer to account for the profits made thereby. [See *Rankin v. Frebank Co.* (1975) 47 CA3d 75, 89, 121 CR 348, 356]

(b) [6:326] **Limitation—no unfair advantage over corporate creditors:** But directors or officers cannot, by purchasing corporate obligations at a discount, secure to themselves any preference or unfair advantage over the other creditors of the corporation in payment of their claims. [See *Rankin v. Frebank Co.* (1975) 47 CA3d 75, 89, 121 CR 348, 357]

[6:326.1] For example, if a corporation is insolvent and in the process of *liquidation*, it may be "inequitable" for an officer or director to purchase a corporate obligation at a discount, and then enforce it at face value against the corporation … at least if the corporation lacked sufficient funds to pay the other creditors. In such cases, the director or officer should receive proportionately no more than paid to the other creditors. [See *Rankin v. Frebank Co.* (1975) 47 CA3d 75, 89, 121 CR 348, 357; and also *Commons v. Schine* (1973) 35 CA3d 141, 144-145, 110 CR 606, 608-609]

[6:327] But this only applies where the corporation is *planning* to *liquidate*: i.e., if the corporation is still a going concern, though insolvent, a director or officer can enforce full payment of obligations purchased at a discount. As long as no liquidation or bankruptcy proceedings have begun, the corporate obligations are enforceable whether in the hands of the director or some third party. The only limitation is that the purchase must be a "fair" one. [See *Rankin v. Frebank Co.* (1975) 47 CA3d 75, 90, 121 CR 348, 348; and *Manufacturers Trust Co. v. Becker* (1949) 338 US 304, 312-314, 70 S.Ct. 127, 132-133]

Comment: Of course, once bankruptcy proceedings commence, enforceability will also be subject to federal bankruptcy law (voidable preferences, etc.).

c. [6:328] **Competing with corporation:** There may be even more of a conflict of interest if the officer or director competes directly with the corporation they are supposedly serving (e.g., by starting a competitive business). The fiduciary duty of loyalty owed to the corporation creates a clear conflict of interest in such cases.

(1) [6:329] **As unfair competition:** Moreover, there are often claims by the corporation that the officer or director wrongfully appropriated corporate assets in launching the competing business. Such acts may be actionable both as breaches of fiduciary duty and unfair competition. Typical examples:

• [6:330] Using *trade secrets* or *customer lists* belonging to the corporation to start a new business; [*Components for Research, Inc. v. Isolation Products, Inc.* (1966) 241 CA2d 726, 729, 50 CR 829, 831]

• [6:331] *"Raiding" key corporate personnel* to launch the competitive business; [*Bancroft-Whitney Co. v. Glen* (1966) 64 C2d 327, 350-352, 49 CR 825, 842-843—knowledge of key employees' salaries and talents enabled officer to take unfair advantage of corporation in launching competitive business]

• [6:332] Usurping corporation's *goodwill* by entertaining, at its expense, prospective customers who are then solicited to do business with officer's own, competing company. [*Bancroft-Whitney Co. v. Glen* (1966) 64 C2d 327, 347, 49 CR 825, 840 fn. 11]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [6:333] **Remedy to corporation:** Where a breach of such a fiduciary duty is shown, the director or officer may be *enjoined* from the unfair competitive acts; and/or held liable for *damages* sustained by the corporation. [See *Bancroft-Whitney Co. v. Glen* (1966) 64 C2d 327, 355-356, 49 CR 825, 845-846]

(Again, if the corporation fails to sue, a derivative action may be maintained on its behalf by any shareholder; *see*¶ *6:602 ff.*)

(3) [6:334] **Compare—investing in competitor:** Arguably, there is a potential conflict of interest where an officer or director invests or obtains a financial interest in *any* business which competes with the corporation (e.g., investing in the stock of a competitor).

However, unless such investment breaches a contractual obligation to the corporation, or usurps a *corporate opportunity*, the investment *by itself* probably does *not* constitute a breach of fiduciary duty. (For example, buying publicly-held shares of a competitor in an open-market transaction does not, by itself, breach a director's duty of loyalty to their corporation.) [See *Robinson, Leatham & Nelson, Inc. v. Nelson* (9th Cir. 1997) 109 F3d 1388, 1392-1394]

4. [6:335] **Controlling Shareholders:** Conflict of interest issues may also arise concerning actions or dealings by controlling shareholders. Their power to control the corporation (by electing directors) carries with it a *fiduciary duty* to exercise such power "fairly" for the benefit of the corporation and the minority shareholders: "The rule that has developed in California is a comprehensive rule of *inherent fairness* from the viewpoint of the corporation and those interested therein." [*Jones v. H.F. Ahmanson & Co*. (1969) 1 C3d 93, 110, 81 CR 592, 601 (emphasis added; internal quotes omitted); see *Steinberg v. Amplica, Inc.* (1986) 42 C3d 1198, 1210, 233 CR 249, 256—there is a "strong public interest in assuring that corporate officers, directors, majority shareholders and others are faithful to their fiduciary obligations to minority shareholders"; and *Sheley v. Harrop* (2017) 9 CA5th 1147, 1171, 214 CR3d 606, 624-625]

a. [6:336] **Transactions between controlling shareholder and corporation:** Controlling shareholders have the burden of proof as to the "fairness" of any dealings between themselves and their corporations. Contracts prejudicial to corporate creditors or minority shareholders may be set aside in equity. [*Efron v. Kalmanovitz* (1964) 226 CA2d 546, 557, 38 CR 148, 155]

(1) [6:337] **Disclosure and approval not sufficient:** The fact that there has been "full disclosure" or "shareholder approval" does *not* insulate such dealings from the requirement of fairness to the corporation. "It would be a shocking concept of corporate morality to hold that because the majority… stockholders disclose their purpose and interest, they may strip a corporation of its assets to their own financial advantage, and that the minority [or creditors] are without legal redress." [*Efron v. Kalmanovitz* (1964) 226 CA2d 546, 556, 38 CR 148, 155, fn. 3]

(2) Application

(a) [6:338] **Purchasing corporate assets:** Majority shareholders cannot purchase for themselves the assets of the corporation on terms unfair to the corporation (e.g., low price, extended terms, no interest), in order to "squeeze out" minority shareholders or deflate the value of their holdings. Any such purchase must be "at arm's length," and the control shareholder bears the *burden of proof* as to the "fairness" of the terms. [*Efron v. Kalmanovitz* (1964) 226 CA2d 546, 556-557, 38 CR 148, 155—control shareholder caused corporation to sell its business to a company he owned for a small down payment, no interest for 5 years, etc., for admitted purpose of eliminating "obnoxious" minority shareholders; *see*¶ *6:342 ff.*]

(b) [6:339] **Obtaining priority over other creditors:** One who dominates and controls an insolvent corporation which owes him money, cannot use his power to secure advantages over other creditors (e.g., to sell its assets and pay off his loan, or to obtain a lien on such assets, leaving the corporation unable to pay its other creditors). "The corporate controller-dominator … occupies a *fiduciary relationship* to its *creditors*. He is liable to those creditors for any preference he has taken for his benefit and to their disadvantage." [*Commons v. Schine* (1973) 35 CA3d 141, 144-145, 110 CR 606, 608-609 (emphasis added)]

(c) [6:340] **Converting stock to debt:** Nor can control shareholders convert a part of their shares to debt (by having the corporation repurchase same for notes, etc.) in order to improve their claims against the assets of an insolvent corporation. Such use of their power breaches their fiduciary duties to the creditors and other shareholders of the corporation. [*In re The Hawaii Corp.* (9th Cir. 1982) 694 F2d 179, 181]

(Such repurchase may also be a prohibited distribution under Corps.C. §§ 500-503; *see¶ 7:10 ff.*)

(d) [6:341] **Forcing repayment of shareholder loans:** Likewise, forcing the corporation to pay off shareholder loans, for the *purpose of injuring* the corporation (leaving it without sufficient capital to continue in business), breaches the controlling shareholders' fiduciary duty to minority shareholders. [*Thrasher v. Thrasher* (1972) 27 CA3d 23, 27, 103 CR 618, 620—husband acted to reduce value of shares owned jointly with wife after marital breakup]

b. [6:342] **Causing corporate action prejudicial to minority shareholders or creditors:** Control shareholders may not manipulate the corporation for their own self-interest, without regard to the interests of the other shareholders or corporate creditors. If they cause corporate action which disadvantages the minority or creditors, they may be held personally liable for the losses sustained. For example:

(1) [6:343] **Issuing shares in order to dilute minority interest:** Even if the articles provide *no* preemptive rights (*see¶ 3:180*), minority shareholders are entitled to protection against "unfair" dilution of their interests. Control shareholders breach their fiduciary duty to the minority where they cause the corporation to issue additional shares for *inadequate consideration*, in order to dilute the minority's interest. The minority shareholders may sue directly for their damages. [Anno., 38 ALR2d 1366]

(2) [6:344] **Dividend policy detrimental to minority:** Similarly, a control shareholder may be held personally liable for causing the directors to adopt dividend policies detrimental to the minority shareholders; e.g., to stop paying dividends (even though ample funds are available) in order to deflate the value of the minority's shares and pressure them into selling out to the majority. [See *Sinclair Oil Corp. v. Levien* (Del. 1971) 280 A2d 717, 721-722]

(3) [6:344.1] **Elimination of preferred shareholders by sale of assets to related corporation:** A pair of shareholders/directors who controlled a majority of the corporation's stock breached their fiduciary duty to the preferred shareholders when they arranged a preferential sale of the corporation's assets to another corporation wholly owned by one of those shareholders/directors (with the other shareholder/director becoming the new corporation's president/CEO). The asset sale forced the selling corporation into bankruptcy and wiped out the interest of the three preferred shareholders, who had made critical investments in the corporation in an effort to keep it afloat and who were informed of the sale only after it occurred. [*Meister v. Mensinger* (2014) 230 CA4th 381, 395, 178 CR3d 604, 615]

(4) [6:345] **Placing corporation in bankruptcy to sell assets to creditor owned by majority shareholder:** A majority shareholder who uses its control over the board of directors to place the corporation into bankruptcy for the purpose of selling the corporation's assets to a secured creditor that is a subsidiary of the controlling shareholder may be liable for breaching its duty to the minority shareholders on the theory that the controlling shareholder failed to consider other alternatives that may have yielded greater value to the corporation and all of its shareholders. [See *Davis v. Yageo Corp.* (9th Cir. 2007) 481 F3d 661, 678-679—plaintiffs' claims concerned *prebankruptcy* conduct and hence not preempted by bankruptcy law (*discussed further at ¶ 6:250*)]

(5) [6:345.1] **Transfer of professional corporation stock to unlicensed individual:***See*¶ 2:256 ff.

(6) [6:345.2] **Compare—no fiduciary duty to warrant holders:** Neither the corporation, nor its controlling shareholders, directors or officers, owe a fiduciary duty to warrant holders. Warrant holders have an *option* to acquire shares, and become shareholders only upon exercise of the warrants. Warrant holders' rights are solely *contractual*. [*Speirs v. BlueFire Ethanol Fuels, Inc.* (2015) 243 CA4th 969, 982, 197 CR3d 25, 36]

This is so even where the warrant holders also happen to be minority shareholders. "These distinct legal relationships —(1) the fiduciary relationship of corporate insiders to minority shareholders and (2) the contractual relationship of corporations and warrant holders—should not be conflated, even if the same individuals are both minority shareholders and warrant holders." [*Speirs v. BlueFire Ethanol Fuels, Inc.*, supra, 243 CA4th at 983, 197 CR3d at 37]

c. [6:346] **Sale of controlling shares:** Control shareholders also have a fiduciary duty to the minority to act with "good faith and inherent fairness" when transferring control of the corporation. [*Jones v. H.F. Ahmanson & Co.* (1969) 1 C3d 93, 112, 81 CR 592, 602; see *Neubauer v. Goldfarb* (2003) 108 CA4th 47, 55-57, 133 CR2d 218, 223-226—minority shareholder's purported waiver of controlling shareholder's duty not enforceable; and *Singhania v. Uttarwar* (2006) 136 CA4th 416, 426, 38 CR3d 861, 867]

(1) Application

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [6:347] **Sale to "looter":** Under some circumstances, the duty to minority shareholders may require reasonable investigation of persons seeking to purchase the control shares. For example, if there are grounds to suspect the purchaser may "loot" the corporation, and the control shareholders proceed with the sale without investigating the purchaser or protecting the corporation, they may be liable for resulting losses. (It makes no difference whether the control shareholders receive any premium for their shares.) [*DeBaun v. First Western Bank & Trust Co.* (1975) 46 CA3d 686, 696-697, 120 CR 354, 359-360—derivative action maintained by minority shareholders against trustee who sold controlling shares to corporate "pirate" who absconded with all of its cash, and left it an empty shell for the minority shareholders]

➪ [6:348] ***PRACTICE POINTER:*** Here are some danger signs that may arouse suspicion that the purchaser intends to "loot" the corporation's assets:

• Willingness to pay an excessive price for the control shares;

• Undue interest in the "liquidity" of corporate assets;

• Relative *lack* of interest in the operating aspects of the corporation's business.

(b) [6:349] **Sale to purchaser planning detrimental changes:** Similar principles apply where the control shareholder has reason to know that the purchaser intends changes in the corporation's operations that will be detrimental to the minority shareholders. [*Brown v. Halbert* (1969) 271 CA2d 252, 268-269, 76 CR 781, 791-792—sellers sold control shares at a premium, knowing that purchasers intended to discontinue dividends and thereby deflate value of minority's shares; and *Perlman v. Feldmann* (2nd Cir. 1955) 219 F2d 173, 177—sellers sold control to purchaser whom they knew would make corporation a "captive" supplier and might limit its profits (by consuming its entire output at prices lower than it could have charged other customers), thereby deflating value of minority's shares]

(c) [6:350] **Not allowing minority shares to participate in "going public":** Control shareholders breach their fiduciary duty to the minority if they *transfer the control shares to a new corporation for the purpose of "going public,"* without allowing the minority to participate—i.e., where no public market exists for the corporation's stock, it would be "inherently unfair" to allow control shareholders to obtain the liquidity and advantages of publicly-held shares, while the minority shareholders were locked into a corporation whose shares were relatively illiquid. [*Jones v. H.F. Ahmanson & Co.* (1969) 1 C3d 93, 112, 81 CR 592, 602]

(d) [6:350.1] **Sale to corporation:** Similarly, controlling shareholders of a closely held corporation may breach their fiduciary duty to the minority where they cause the corporation to repurchase the shares of a member of the controlling group, but do not offer minority shareholders equal repurchase rights. Reason: "[T]he controlling group may not utilize its control of the corporation to establish an exclusive market in previously unmarketable shares from which the minority stockholders are excluded." [*Donahue v. Rodd Electrotype Co. of New England, Inc.* (MA 1975) 328 NE2d 505, 518 (citing *Jones v. H.F. Ahmanson*, supra)]

(e) [6:351] **Sale of shares accompanied by resignation of directors:** Typically, sale of control shares is conditioned upon a majority of the present board tendering their resignations and appointing the purchaser's designees, so that the purchaser gains immediate control of the management. This is proper as long as the number of shares sold would entitle the purchaser to such control of the board (i.e., shares sufficient to elect that number of directors under cumulative voting).

However, if the shares sold would *not* be sufficient to elect that number of directors at a shareholders' meeting, the arranged resignations may be invalid as constituting the "sale of corporate office (or directorships)." [*Petition of Caplan* (N.Y. A.D. 1964) 246 NYS2d 913, 915-916, aff'd without opn. (1964) 249 NYS2d 877—sale of 3% of Lionel Corp. accompanied by seriatim resignations by a majority of board held invalid]

(f) [6:352] **Compare—simply obtaining premium for control:** No California case has yet held that the premium obtained by a control shareholder for their shares must, as a general rule, be shared with the minority shareholders. In each of the cases in which a breach of duty was found, and the control shareholder required to disgorge the premium, there was some *additional element:* e.g., corporate looting, sale of corporate office, harm to the corporate business, misrepresentations to minority shareholder, etc.

Nevertheless, it has been *argued* that "control" of the corporation is a corporate asset, so that all shareholders should be entitled to share pro rata in any premium obtained by the control shareholders for their shares. [See authorities cited in *Jones v. H.F. Ahmanson & Co.* (1969) 1 C3d 93, 111, 81 CR 592, 601-602] (Again, however, no California case has yet adopted this view.)

Note that Delaware law permits a large shareholder to receive a premium for their shares instead of participating in a pro rata sale with the other shareholders. [*Thorpe v. CERBCO, Inc.* (Del. 1996) 676 A2d 436, 442; *In re Morton's Restaurant Group, Inc. Shareholders Litig.* (Del.Ch. 2013) 74 A3d 656, 671, fn. 80]

➪ [6:353] ***PRACTICE POINTER:*** The risk of litigation is high where the control shareholder gets a "better deal" for their shares than is available to the other shareholders of the corporation. [See *Neubauer v. Goldfarb* (2003) 108 CA4th 47, 50, 133 CR2d 218, 221 (controlling shareholders sued for causing corporation to repurchase minority shareholder's interest at $70 per share shortly before they sold out to third party at $347 per share)]

If you represent the seller of control shares, the safest course is to negotiate a similar offer at the same price to all shareholders—even if it means the seller receiving a slightly lower price for their shares.

If your client refuses, advise them to be prepared to defend against claims or lawsuits by minority shareholders.

In such cases, try to "build a record" to show that the seller exercised reasonable care to ascertain the buyer's plans for the corporation; and had no grounds to suspect that the transfer of control would be prejudicial to the minority shareholders. If this can be shown, the minority shareholders will have to rest their case on the theory that "control" is a corporate asset to be shared by all shareholders; and, as stated, no California case has yet squarely adopted this position.

(2) [6:354] **Remedy:** The remedy against the controlling shareholder is an action for damages—either by the corporation (in the form of a derivative suit brought by the minority shareholders, *see*¶ *6:602 ff.*) or by the minority shareholders directly (individually, or as a class action):

(a) [6:355] **Derivative suit for damage to corporation:** Where the sale has resulted in injury to the *corporation* (e.g., "looting" by purchaser), the remedy belongs to the corporation. If it fails or refuses to sue (as where the control shares are still held by the "looter"), a minority shareholder may file a *derivative* suit on behalf of the corporation. [*De Baun v. First Western Bank & Trust Co.* (1975) 46 CA3d 686, 696-697, 120 CR 354, 359-360]

The measure of damages is the injury to the corporation. For example, where sale to a "looter" resulted in the corporation being left without assets and forced out of business, the party who sold the control shares to the "looter" was held liable for the assets looted, *plus* loss of earning power (goodwill), *plus* costs of defending and paying corporate debts left by the looter. [*De Baun v. First Western Bank. & Trust Co.,* supra]

(b) [6:356] **Damages action by minority shareholders individually (or class action):** Where the purchaser of the control shares still owns those shares, it may be "inequitable" for the corporation to recover—because its recovery would enhance the value of the control shares, thus giving the purchaser an unwarranted refund on the purchase price. Consequently, courts allow the minority shareholders to recover *individually* (or as a class) their proportionate share of the premium paid by the purchaser for control of the corporation. [See *Brown v. Halbert* (1969) 271 CA2d 252, 272, 76 CR 781, 794; and *Perlman v. Feldmann* (2nd Cir. 1955) 219 F2d 173, 178]

(c) [6:357] **Compare—damages resulting from "freeze out":** Where, in order to "freeze out" the minority, the majority shareholders transferred their shares to a wholly-owned corporation, and "went public" with that corporation (without giving the minority a chance to participate), the minority shareholders were entitled to receive, at their election, *either:* (i) the appraised value of their shares at the time of such transfer, plus interest, less dividends; or (ii) an amount equal to the value of the shares that should have been offered to them in the public corporation. [*Jones v. H.F. Ahmanson & Co.* (1969) 1 C3d 93, 115-117, 81 CR 592, 604-606]

[6:357.1 - 6:357.4] ***Reserved.***

(d) [6:357.5] **No jury trial in breach of fiduciary duty action:** A breach of fiduciary duty claim against a controlling shareholder is *equitable* in nature and thus is *not* triable by jury. [*Interactive Multimedia Artists, Inc. v. Sup.Ct. (Allstate Ins. Co.)* (1998) 62 CA4th 1546, 1555-1556, 73 CR2d 462, 468-469]

5. [6:358] **Insider Trading:** Conflict of interest issues may also be raised in connection with the purchase or sale of the corporation's securities by its directors, officers or other "insiders." Their access to "inside" information (e.g., changes in the corporation's financial condition or business prospects) may enable them to profit personally by trading the corporation's securities. But their relationship to the corporation and its stockholders subjects them to certain duties and liabilities as discussed below (¶ 6:359 ff.):

a. [6:359] **Federal securities laws:** Insider trading is subject to regulation under several provisions of the Securities Exchange Act of 1934 (SEA).

(1) [6:360] **SEC Rule 10b-5:** SEC Rule 10b-5 was promulgated pursuant to authority granted in Section 10(b) of the SEA. [See SEA § 10(b) (15 USC § 78j(b)); Rule 10b-5 (17 CFR § 240.10b-5)]

Rule 10b-5 prohibits the following acts in connection with the purchase or sale of securities, through use of the mails or any instrumentality of interstate commerce:

- To employ any "device, scheme or artifice to defraud"; or

- To engage in any act, practice or course of business "which operates or would operate as a fraud or deceit" upon any person; or

- "To make any *untrue statement* of a *material* fact or to *omit* to state a material fact necessary in order to make the statements made … not misleading." [17 CFR § 240.10b-5 (emphasis added); see *Lorenzo v. SEC* (2019) 587 US 71, 80-81, 139 S.Ct. 1094, 1102—acknowledging overlap between first and second prongs (i.e., "device, scheme or artifice to defraud" may also constitute act "which operates or would operate as a fraud or deceit"); *ESG Capital Partners, LP v. Stratos* (9th Cir. 2016) 828 F3d 1023, 1032]

Neither the statute nor the Rule expressly provides any private remedies (¶ 6:373 ff.). But courts recognize an implied private right of action to recover damages for a Rule 10b-5 violation. [See *Halliburton Co. v. Erica P. John Fund, Inc.* (2014) 573 US 258, 267, 134 S.Ct. 2398, 2407; *Janus Capital Group, Inc. v. First Derivative Traders* (2011) 564 US 135, 141-142, 131 S.Ct. 2296, 2301-2302; *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit* (2006) 547 US 71, 79, 126 S.Ct. 1503, 1509]

(a) [6:361] **Broad scope of Rule:** SEC Rule 10b-5 applies to purchases or sales of securities *regardless* whether such securities are registered under federal law. It applies whether the corporation is large or small, and whether the securities are closely-held or widely traded. [See *Overton v. Todman & Co., CPAs, P.C.* (2nd Cir. 2007) 478 F3d 479, 488; *Hooper v. Mountain States Secur. Corp.* (5th Cir. 1960) 282 F2d 195, 201]

(b) [6:362] **Interstate commerce requirement:** The only limitation is jurisdictional: The securities transaction must involve the use of the mails, telephone or some other instrumentality of interstate commerce. [SEA § 3(a)(17) (15 USC § 78c(a)(17))]

Conceivably, if a purchase and sale could be conducted from beginning to end in a single state, through face-to-face dealings, the SEA would not apply. But, as a practical matter, this is rarely possible.

1) [6:362.1] **Limited transnational application:** The SEA defines "interstate commerce" to include commerce "between any foreign country and any State." [SEA § 3(a)(17) (15 USC §§ 78c(a)(17))]

Nevertheless, § 10(b), and hence Rule 10b-5, applies only to the *purchase or sale* of a security *in the U.S.* or *listed on a U.S. stock exchange*. Manipulative or deceptive conduct occurring in the U.S. in connection with a purchase by or sale of securities to *foreign investors in another country* is *not* actionable under Rule 10b-5. [*Morrison v. National Australia Bank Ltd.* (2010) 561 US 247, 255-273, 130 S.Ct. 2869, 2877-2888; see SEA § 10(b) (15 USC § 78j(b)); SEC Rule 10b-5 (17 CFR § 240.10b-5); *Stoyas v. Toshiba Corp.* (9th Cir. 2018) 896 F3d 933, 945-947—OTC Link (over-the-counter market operated by OTC Markets Group) is registered with SEC as "alternative trading system" and is *not* an "exchange"]

a) [6:362.2] **Compare—foreign fraudulent conduct directed at U.S.:** Fraudulent conduct occurring abroad *directed at U.S. securities markets or investors* and resulting in a *purchase or sale in the U.S.* may be actionable under SEA § 10(b) and SEC Rule 10b-5. [*Morrison v. National Australia Bank Ltd.* (2010) 561 US 247, 255-273, 130 S.Ct. 2869, 2877-2888; *see* ¶ *5:57.1*]

The "irrevocable liability" test is used to determine whether a purchase or sale takes place in the U.S. Under this test, Rule 10b-5 may apply to extraterritorial conduct if:

• The *purchasers* incurred irrevocable liability in the U.S. to *take and pay* for the securities;

• The *sellers* incurred irrevocable liability in the U.S. to *deliver* the securities; *or*

• *Title* to the securities was *transferred* in the U.S. [*Stoyas v. Toshiba Corp.* (9th Cir. 2018) 896 F3d 933, 948-949] Relevant facts directly relating to the consummation of a purchase or sale include contract formation, placement of purchase orders, passing of title and the exchange of money. [*Stoyas v. Toshiba Corp.*, supra, 896 F3d at 949]

(c) [6:363] **Persons liable under 10b-5:** Persons who use *inside (nonpublic) information* to trade securities in *breach of a fiduciary duty* or other unlawful means engage in the type of "*fraud*" or "*deceit*" proscribed by SEC Rule 10b-5 (*¶ 6:360*). The most important cases under the Rule involve unlawful trades committed by corporate "insiders," their "tippees" and persons outside the corporation who misuse inside information for their own personal benefit. [See *United States v. O'Hagan* (1997) 521 US 642, 651-652, 117 S.Ct. 2199, 2207; *United States v. Bhagat* (9th Cir. 2006) 436 F3d 1140, 1148-1149]

1) [6:364] **Insiders ("classical theory"):** Corporate insiders (directors, officers, employees, etc.) have a *fiduciary duty* toward the *shareholders*. Insiders breach this duty when they purchase or sell the corporation's securities through the use of material information *not known* to the other parties to the transaction (i.e., present or future shareholders). This is sometimes referred to as "insider," "classical" or "traditional" 10b-5 liability. [See *Salman v. United States* (2016) 580 US 39, 41-42, 46, 137 S.Ct. 420, 423, 425, fn. 2; *United States v. O'Hagan* (1997) 521 US 642, 651-653, 117 S.Ct. 2199, 2207; *SEC v. Texas Gulf Sulphur Co*. (2nd Cir. 1968) 401 F2d 833, 848]

a) [6:365] **Noncorporate personnel as "temporary" insiders:** The same rule applies to others with access to "inside" information: attorneys, accountants, consultants and others who trade on nonpublic information received confidentially from the corporation. Such persons temporarily become fiduciaries of the corporation and are also treated as "insiders." [See *United States v. O'Hagan* (1997) 521 US 642, 652, 117 S.Ct. 2199, 2207; *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (2nd Cir. 1974) 495 F2d 228, 237]

b) [6:365.1] **Providing inside information to "tippees" prohibited:** Insiders are not only forbidden from using inside information for their own advantage, but are also prohibited from disclosing such information to outsiders ("tippees") for the same improper purpose of exploiting the information for personal gain.

[6:365.2] **Limitation:** However, to be liable for breach of fiduciary duty, the insider must realize directly or indirectly some personal gain. Thus, where the insider does not personally trade on the inside information, some other personal benefit must be present in giving the tip—e.g., the "reputational benefit" or personal satisfaction from making a "gift" of such information to relatives, friends or business colleagues. [See *Salman v. United States* (2016) 580 US 39, 42, 137 S.Ct. 420, 423; *Dirks v. SEC* (1983) 463 US 646, 662-664, 103 S.Ct. 3255, 3265-3266; *SEC v. Warde* (2nd Cir. 1998) 151 F3d 42, 48-49; *and ¶ 6:366.1a*]

2) [6:366] **Tippees:** "Tippees" are also forbidden from participating in the tippor's breach of fiduciary duty *if they knew or should have known* the information was confidential and the disclosure thus a breach of the insider's fiduciary duty. [*Salman v. United States* (2016) 580 US 39, 42, 137 S.Ct. 420, 423; *Dirks v. SEC* (1983) 463 US 646, 660, 103 S.Ct. 3255, 3264]

a) [6:366.1] **Tippee's derivative liability:** Thus, a tippee's liability is *derivative* of the breach of the insider-tippor: i.e., there is no tippee liability unless the tippor has breached their insider duty. [*Salman v. United States* (2016) 580 US 39, 42, 137 S.Ct. 420, 423; *Dirks v. SEC* (1983) 463 US 646, 659, 103 S.Ct. 3255, 3264; *United States v. Chestman* (2nd Cir. 1991) 947 F2d 551, 571; *see ¶ 6:367*]

b) [6:366.1a] **Confidential information as "gift":** Although there is no tippee liability unless the tippee knows that the tippor received a benefit from the tip (¶ 6:365.2), the benefit need not have pecuniary or similar value. Where confidential information is provided to a tippee as a "gift," the tippee need only know that the tippor intended to benefit the tippee by disclosing material nonpublic information with the expectation that the tippee will trade on the information. [*Salman v. United States* (2016) 580 US 39, 48-50, 137 S.Ct. 420, 427-428; *Dirks v. SEC* (1983) 463 US 646, 664-667, 103 S.Ct. 3255, 3266-3268; see *United States v. Martoma* (2nd Cir. 2018) 894 F3d 64, 73-79]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

3) [6:366.2] **Insiders liable to tippees:** Tippees losing money in reliance on insider-tippors, who deliberately provide them with false "inside" information to manipulate trading in a company's stock, may be able to recover damages from the tippors.

a) [6:366.3] **Tippees ordinarily not subject to "in pari delicto" defense:** Tippees are *inherently not* as culpable as insider-tippors. (Rationale: Their liability is derivative (¶ 6:366.1); and tippors, by breaching their fiduciary duties to the issuer, have committed fraud upon their company as well as upon the tippees.) Thus, a tippee's private damages action is ordinarily not subject to the "in pari delicto" (equal culpability) defense … *unless:* (i) the tippee is *equally* as culpable as the tippor (e.g., they committed other culpable actions beyond merely being a "tippee"); *and* (ii) barring the suit "would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public." [*Bateman Eichler, Hill Richards, Inc. v. Berner* (1985) 472 US 299, 311, 105 S.Ct. 2622, 2629; see also *Rothberg v. Rosenbloom* (3rd Cir. 1986) 808 F2d 252, 255; *Ross v. Bolton* (2nd Cir. 1990) 904 F2d 819, 824-825]

b) [6:366.4] **Effect:** This seemingly places tippees in a "no lose" situation: able to "reap illicit benefits" if the tip succeeds, or sue their tippor if it fails. However, they are subject to penalties under the Insider Trading Sanctions Act (¶ *6:374.1*), and are potentially liable under SEA § 10(b) and SEC Rule 10b-5 (¶ 6:366). Also, due to the scienter requirement (¶ *6:371*), they may bring suit only if they have been *deliberately defrauded*—not if they were inadvertently given a bad "tip." [See *Bateman Eichler, Hill Richards, Inc. v. Berner* (1985) 472 US 299, 316-319, 105 S.Ct. 2622, 2632-2633]

4) [6:367] **"Outsider" liability ("misappropriation" theory):** Persons outside the corporation have no fiduciary duty toward the shareholders and thus *cannot* be held liable under the "classical" theory of SEC Rule 10b-5 liability (¶ *6:364*). Nevertheless, they may be liable under the "misappropriation" theory if they trade on nonpublic information in breach of a duty owed to the *source of the information:*

"Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information." [*United States v. O'Hagan* (1997) 521 US 642, 652, 117 S.Ct. 2199, 2207; see *Salman v. United States* (2016) 580 US 39, 46, 137 S.Ct. 420, 425, fn. 2; *SEC v. Talbot* (9th Cir. 2008) 530 F3d 1085, 1092-1096]

a) [6:367.1] **Example:** A partner in a law firm retained by a company that planned a tender offer violated SEC Rule 10b-5 when he secretly purchased the target company's securities for his own account in advance of the offer. The attorney's use of the information breached his duty of trust and confidence owed to both his law firm and its client and thus constituted a "fraudulent device in connection with the purchase and sale of securities" (¶ *6:360*). [*United States v. O'Hagan* (1997) 521 US 642, 647-653, 117 S.Ct. 2199, 2205-2208; see *SEC v. Cuban* (5th Cir. 2010) 620 F3d 551, 556-558—agreement to maintain in confidence information obtained from CEO may have included agreement not to trade on that information; *SEC v. Dorozhko* (2nd Cir. 2009) 574 F3d 42, 49—trading on inside information obtained through computer hacking may result in 10b-5 liability]

1/ [6:367.1a] **Comment:** Thus, attorneys, doctors, psychiatrists and others who receive information in confidence may perpetrate a deception on their clients/patients when they misappropriate the information and trade on it in breach of their duty of confidentiality.

[6:367.1b - 6:367.1e] *Reserved.*

b) [6:367.1f] **Breach of personal relationship (SEC Rule 10b5-2):** A duty of *trust or confidence* sufficient to support liability under the misappropriation theory exists in the following circumstances:

- Whenever a person *agrees* to maintain *material nonpublic information* in *confidence* (i.e., a written or oral bilateral agreement, including an agreement that is unspoken but implicit in the circumstances); *or*

- Whenever a person communicates the information to another person with whom there is a *history, pattern or practice of sharing confidences*, such that the recipient *knows or reasonably should know* they are expected to maintain confidentiality; *or*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- Whenever a person receives or obtains the information from a *spouse, parent, child or sibling* … unless the recipient can show that the person providing the information had no reasonable expectation the information would be kept confidential because the parties had neither a history, pattern or practice of sharing confidences nor any understanding to maintain the confidentiality of the information. [17 CFR § 240.10b5-2]

  These are *not*, however, the exclusive circumstances in which a duty of trust or confidence may arise for purposes of "misappropriation" liability. [See Preliminary Note to 17 CFR § 240.10b5-2]

  ➪ [6:367.1g] ***PRACTICE POINTER:*** SEC Rule 10b5-2 underscores the need to be cautious about sharing material nonpublic information with others: *Don't do it*—except on a *strictly "need to know" basis.* Laxity in sharing such information can expose family and friends to sanctions and liability for their subsequent poor judgment in misusing the information.

c) [6:367.2] **Disclosure avoids liability:** Full disclosure of the "outsider's" intention to trade forecloses SEC Rule 10b-5 liability: "Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no SEA § 10(b) violation …" [*United States v. O'Hagan* (1997) 521 US 642, 655, 117 S.Ct. 2199, 2209]

1/ [6:367.3] **Compare—*state law liability not vitiated by disclosure:*** Though disclosure may avoid SEC Rule 10b-5 liability, it does *not* necessarily avoid liability for, e.g., breach of a duty of loyalty under state (or other) law. [*United States v. O'Hagan* (1997) 521 US 642, 655, 117 S.Ct. 2199, 2209]

2/ [6:367.4] **Caution—disclosure to multiple sources:** Where the nonpublic information is obtained in violation of a duty owed to *more than one* entity, disclosure will avoid SEC Rule 10b-5 liability only if made to *all* the entities. [*United States v. O'Hagan* (1997) 521 US 642, 655, 117 S.Ct. 2199, 2209, fn. 7—partner who used confidential information in breach of duty owed to law firm and client could avoid 10b-5 liability only by disclosure to both]

d) [6:368] **"Misappropriation" theory limited to injunctive/criminal actions?** The cases to date, including the Supreme Court's decision in *O'Hagan*, supra, involve SEC injunctive or criminal actions, where the legal theories and liabilities differ from cases involving "insider" tipping/*civil* liability.

- For example, *outsider tippers and tippees* are *criminally* liable even where the tipper does not trade on the misappropriated information; criminal liability attaches upon proof the misappropriators knew confidential information was communicated (i.e., a duty was breached). In contrast to insider tipping cases, proof is *not* required that the tipper realized some personal gain or knew the tippee would engage in illicit trades. [See *UnitedStates v. Libera* (2nd Cir. 1993) 989 F2d 596, 600; *United States v. Falcone* (2nd Cir. 2001) 257 F3d 226, 234—"To support a conviction of the tippee defendant, the government was simply required to prove a breach by … the tipper of a duty owed to the owner of the misappropriated information, and defendant's knowledge that the tipper had breached the duty"; and *SEC v. Cherif* (7th Cir. 1991) 933 F2d 403, 411-412; but see also *SECv. Yun* (11th Cir. 2003) 327 F3d 1263, 1274-1280—SEC must prove "intent to benefit" in outsider tipper case; *and ¶ 6:366.1a*]

  In such injunctive or criminal cases, however, the penalties sought may include *disgorgement* of the misappropriator's (and even their tippee's) profits. [*SEC v. Clark* (9th Cir. 1990) 915 F2d 439, 453—misappropriation theory upheld based on its compatibility with "[t]he 'peculiar blend of legislative, administrative, and judicial history' surrounding § 10(b) and Rule 10b-5"; *SEC v. Maio* (7th Cir. 1995) 51 F3d 623, 631; but see *Moss v. Morgan Stanley Inc.* (2nd Cir. 1983) 719 F2d 5, 16—misappropriation does not give rise to civil liability]

[6:368.1] ***Reserved.***

e) [6:368.1a] **Compare—1988 Insider Trading and Securities Fraud Enforcement Act:** Under this law, anyone who purchases (or sells) securities in violation of any provision of the SEA is liable to any person on the opposite side of the market who contemporaneously sells (or purchases) securities of the same class. Persons liable include

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

those violating Rule 10b-5 (whether as "insiders" under the "classical" theory of liability or "outsiders" under the "misappropriation" theory) as well as persons violating Rule 14e-3. [SEA § 20A(a) (15 USC § 78t-1(a)); see SEC Rule 10b-5 (17 CFR § 240.10b-5); SEC Rule 14e-3 (17 CFR § 240.14e-3); *Johnson v. Aljian* (9th Cir. 2007) 490 F3d 778, 781-783—§ 20A(a) claim does not require actionable predicate violation (underlying 10b-5 violation actionable under § 20A(a) even if time-barred under 10b-5 limitations period; *see*¶ *6:375.3*); *In re AST Research Secur. Litig.* (CD CA 1995) 887 F.Supp. 231, 232-235]

In enacting this law, Congress "specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory" (e.g., *Moss v. Morgan Stanley Inc.*, supra). [*SEC v. Clark* (9th Cir. 1990) 915 F2d 439, 452]

The Act also imposes liability on tippors and controlling persons of those who trade on inside information in violation of Rule 10b-5 (*see*¶ *6:374.1 ff.*). [SEA § 20A(b)(3), (c) (15 USC § 78t-1(b)(3), (c)); cf. *In re AST Research Secur. Litig.*, supra, 887 F.Supp. at 235—no tippor liability for employee's disclosure of information to coemployees who trade (communication of corporate information within corporation not illegal)]

(*Note:* In view of the Supreme Court's ruling in *O'Hagan*, supra, that a misappropriator violates Rule 10b-5 not because of a duty toward contemporaneous traders, but because of a duty owed to the information *source*, contemporaneous traders may have to rely exclusively on the Act to recover against misappropriators. See *United States v. O'Hagan* (1997) 521 US 642, 665, 117 S.Ct. 2199, 2214, fn. 11 (declining to address significance of SEA § 20A).)

f) [6:368.1b] **Compare—Rule 14e-3 liability (tender offers):** SEC Rule 14e-3 pertains specifically to pending tender offers. It prohibits any person from trading on the basis of material nonpublic information that they know (or have reason to know) has been acquired *directly or indirectly* from (i) the offeror, (ii) the target, (iii) any officer, director, partner or employee of the offeror or target, or (iv) *any other person "acting on behalf of"* the offeror or target. [SEC Rule 14e-3(a) (17 CFR § 240.14e-3(a)); see *United States v. Chestman* (2nd Cir. 1991) 947 F2d 551, 556-563]

"Tippee" liability under Rule 14e-3 requires neither breach of a fiduciary duty (*see*¶ *6:363*) nor personal benefit to the tippor (*see*¶ *6:365.2*), and hence is considerably broader in scope than Rule 10b-5 liability: i.e., a securities trade permissible under 10b-5 may nevertheless lead to liability under 14e-3. [See *United States v. O'Hagan* (1997) 521 US 642, 666-677, 117 S.Ct. 2199, 2214-2219 (upholding validity of Rule 14e-3); *United States v. Chestman*, supra]

g) [6:368.1c] **Compare—mail and wire fraud liability:** Persons who misappropriate confidential business information through use of the mail or electronic transmissions may also be *criminally* liable under the federal mail and wire fraud statutes (18 USC §§ 1341, 1343). [See *United States v. Carpenter* (1987) 484 US 19, 27-28, 108 S.Ct. 316, 321-322; also see *United States v. O'Hagan* (1997) 521 US 642, 677-678, 117 S.Ct. 2199, 2219-2220 & fn. 25]

➪ [6:368.2] ***PRACTICE POINTER:*** You should exercise utmost care in preserving the confidences of a corporate client in all circumstances. Clearly instruct all personnel in your firm *not* to trade securities of your clients, or tip others to do so, based on nonpublic information—*regardless* of how they acquire such information.

5) [6:368.2a] **No liability where no breach of duty:** Not *everyone* in possession of material nonpublic information has a duty to refrain from trading on it to their advantage. Where the information was obtained through *no breach of duty* or other prohibited means, use of that information to trade securities does *not* violate SEC Rule 10b-5.

Examples: Thus, the following persons were found *not* liable under 10b-5:

- A broker who dug up crucial information on his own and alerted his clients. [*Dirks v. SEC* (1983) 463 US 646, 649-667, 103 S.Ct. 3255, 3258-3268]

- A tippor (and his broker tippee) who learned of an impending tender offer from his wife, the niece of the target corporation's president/controlling shareholder. [See *United States v. Chestman* (2nd Cir. 1991) 947 F2d 551, 571; *but also see*¶ *6:368.1b* for special rules pertaining to tender offers]

- A purchaser who obtained inside information by inadvertently overhearing a conversation at a track meet. [*SEC v. Switzer* (WD OK 1984) 590 F.Supp. 756, 764]

[6:368.2b - 6:368.2i] ***Reserved.***

6) [6:368.2j] **Actual use of inside information *not required ("knowing possession" standard):*** Insider trading liability, whether under the "classical" theory (*¶ 6:364*) or "misappropriation" theory (*¶ 6:367*), requires that the trade be made "*on the basis of*" material nonpublic information. Some courts, including the Ninth Circuit, have required a showing that the trader actually *used* the information in deciding to buy or sell securities. [*United States v. Smith* (9th Cir. 1998) 155 F3d 1051, 1066-1069; compare *United States v. Teicher* (2nd Cir. 1993) 987 F2d 112, 119-121—"actual use" standard rejected in favor of "knowing possession" standard]

However, in SEC Rule 10b5-1, the SEC adopted the "knowing possession" standard: A purchase or sale of a security is made "on the basis of" material nonpublic information if the trader *is aware* (i.e., "knows") of such information when making the trade. Because the SEC promulgated Rule 10b5-1 after the Ninth Circuit's decision in *United States v. Smith*, supra, the SEC's interpretation should control. [17 CFR § 240.10b5-1(b); see *SEC v. Moshayedi* (CD CA 2013) 2013 WL 12172131, *13-14]

Significantly, the Rule contains two narrow defenses that are based on a showing that, although the defendant was aware of the information when trading, the information was not a causal factor in the decision to trade:

a) [6:368.2k] **Exception—trading pursuant to prior binding contract or plan:** A person "aware" of material nonpublic information at the time of the *trade* may nevertheless avoid liability by proving that, *before becoming aware of the information*, they either (i) entered into a binding contract to make the trade, (ii) instructed someone to make the trade for their account, or (iii) adopted a written plan for trading pursuant to which the trade was made. [17 CFR § 240.10b5-1(c)(1)(i)(A), (C)]

Further, the contract, instruction or plan must have either:

- Specified the *amount* to be purchased or sold, the *trade date* and the *price* (which may be "at market" on a particular date or a limit price); or
- Included a written *formula*, *algorithm* or *computer program* for determining amount, price and date; or
- Permitted the person to exercise *no subsequent influence* over how, when or whether to effect purchases or sales. [17 CFR § 240.10b5-1(c)(1)(i)(B), (iii)]

b) [6:368.2*l*] **Exception—trading by employee of entity having established safeguards:** This defense, available only to an *entity* (i.e., a person other than a natural person), permits the entity to avoid insider trading liability by demonstrating that:

- The individual(s) making the trading decision on behalf of the entity was *not aware* of the material nonpublic information, *and*
- The entity had in place *reasonable policies and procedures* designed to prevent trading on the basis of material nonpublic information (e.g., "trading windows," internal information barriers, etc.). [17 CFR § 240.10b5-1(c)(2)]

c) [6:368.2m] **California follows SEC Rule 10b5-1(c):**Corps.C. § 25402, like SEC Rule 10b5-1, imposes liability upon insiders who trade in the corporation's securities when they have *knowledge* of material information not available to the public generally (*¶ 6:382 ff.*). However, for purposes of § 25402, an insider is deemed *not* to have traded with knowledge of material inside information if the trade complied with SEC Rule 10b5-1(c) (*¶ 6:368.2k ff.*). [Commr. Rule 260.402]

7) [6:368.3] **Controlling persons:** "Controlling persons" (e.g., directors, officers, employers) of those who violate SEC Rule 10b-5 are *expressly* made jointly and severally liable under the SEA … *unless* they carry the burden of showing they acted in good faith and did not induce the violative acts. [SEA § 20(a) (15 USC § 78t(a)); 17 CFR § 230.405; *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.* (9th Cir. 2003) 320 F3d 920, 945-946; *Howard v. Everex Systems, Inc.* (9th Cir. 2000) 228 F3d 1057, 1065; *Paracor Finance, Inc. v. General Elec. Capital Corp.* (9th Cir. 1996) 96 F3d 1151, 1161; see also SEA § 20A(b)(3)**, (c) (**15 USC § 78t-1(b)(3), (c)); *and discussion at*¶ *6:374.1a*]

a) [6:368.3a] **What constitutes "control":** The Ninth Circuit's general test for "controlling person" is the power to direct or cause the direction of the corporation's *management and policies*. However, the Ninth Circuit acknowledges that this is an "intensely factual question, involving scrutiny of the day-to-day affairs of the corporation and the defendant's power to control corporate actions." [*Howard v. Everex Systems, Inc.* (9th Cir. 2000) 228 F3d 1057, 1065; *Arthur Children's Trust v. Keim* (9th Cir. 1993) 994 F2d 1390, 1396—joint venture's management committee constituted "control group"; compare *Paracor Finance, Inc. v. General Elec. Capital Corp.* (9th Cir. 1996) 96 F3d 1151, 1162-1163—lender that neither exercised control over corporate borrower's management and policies nor directed its day-to-day affairs not liable as controlling person]

Some courts have expressed the test as imposing upon plaintiff the burden of proving defendant had the power:

- To control the *general affairs* of the corporate violator at the time of the violation; *and*
- To control or influence, directly or indirectly, the *specific corporate policy* that resulted in the violation. [See *Brown v. Enstar Group, Inc.* (11th Cir. 1996) 84 F3d 393, 396]

b) [6:368.3b] **"Vicarious control" liability:** "Controlling persons" may also be liable under the common law doctrine of *respondeat superior*. [*Hollinger v. Titan Capital Corp.* (9th Cir. 1990) 914 F2d 1564, 1576-1578—SEA § 10(a) supplements, but does not supplant, respondeat superior; *In re Network Equip.Technologies, Inc. Litig.* (ND CA 1991) 762 F.Supp. 1359, 1363-1366; *but see* ¶ *6:368.7*]

[6:368.3c - 6:368.3g] ***Reserved.***

8) [6:368.3h] **Federal government officials and employees:** SEC Rule 10b-5 prohibitions on insider trading apply to members of Congress and judicial officers, as well as to congressional, judicial and executive branch employees. Such persons may not trade on *material, nonpublic information* obtained *in the performance of their official responsibilities*. [SEA § 21A(g), (h) (15 USC § 78u-1(g), (h))]

9) [6:368.3i] **ERISA fiduciaries (ESOP administrators):** Administrators of employee stock option plans are subject to SEC Rule 10b-5 liability. *See*¶ 6:406.6 ff.

10) [6:368.4] **No "aiding and abetting" liability:** There is no liability for "aiding and abetting" a SEC Rule 10b-5 violation. Reason: Liability can exist under § 10(b) only for conduct that is *expressly proscribed*. [*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* (1994) 511 US 164, 191, 114 S.Ct. 1439, 1455; *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (2008) 552 US 148, 158, 128 S.Ct. 761, 768-769; see *Janus Capital Group, Inc. v. First Derivative Traders* (2011) 564 US 135, 142-147, 131 S.Ct. 2296, 2302-2305—mutual fund's investment advisor that prepared statements in fund's prospectus did not "make" statements and hence not liable under Rule 10b-5 for misrepresentations therein]

a) [6:368.5] **Primary liability *not affected:*** While *Central Bank* represents a significant victory for accountants, attorneys and similar "secondary" actors who had often been the subject of SEA § 10(b) "aiding and abetting" claims, it does not completely free them from liability. The Supreme Court specifically noted that any such person "may be liable as a primary violator under SEC Rule 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." [*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* (1994) 511 US 164, 191, 114 S.Ct. 1439, 1455 (emphasis in original); *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (2008) 552 US 148, 166, 128 S.Ct. 761, 773-774 (but finding no primary liability on facts; *see*¶ *6:368.5g*)]

- [6:368.5a] Thus, notwithstanding *Central Bank,* an accounting firm may be primarily liable for preparing a fraudulent audit opinion that was included in a corporation's report filed with SEC. [*McGann v. Ernst & Young* (9th Cir. 1996) 102 F3d 390, 393-396]
- [6:368.5b] Similarly, *Central Bank* does not preclude a law firm from being primarily liable for its affirmative misrepresentations (or omissions) made to prospective purchasers of the client's stock. [*Thompson v. Paul* (9th Cir. 2008) 547 F3d 1055, 1063—former CFO who accepted company stock in settlement of her civil suit against company stated primary liability claim against company's outside attorneys who falsely represented that CEO was not subject of criminal investigation; *Rubin v. Schottenstein, Zox & Dunn* (6th Cir. 1998) 143 F3d 263, 267-268—issuer's outside counsel who spoke with investors primarily liable for not disclosing that stock issuance

would trigger default under issuer's credit agreement with bank; *Kline v. First Western Government Secur., Inc.* (3rd Cir. 1994) 24 F3d 480, 485-486 & fn. 4—law firm primarily liable for misrepresentations contained in tax opinions rendered in connection with securities straddles]

Nor does *Central Bank* preclude primary liability for a law firm's affirmative misrepresentations (or omissions) made to prospective purchasers on behalf of a client seller of stock. [*ESG Capital Partners, LP v. Stratos* (9th Cir. 2016) 828 F3d 1023, 1033-1035—law firm partner made misrepresentations regarding client who purported to act as intermediary in effecting stock sales but who actually stole purchasers' funds]

• [6:368.5c] And, though *Central Bank* compelled dismissal of an aiding and abetting claim, plaintiffs successfully stated a primary violation claim against accountants who participated in deceptive financial reports, a prospectus and press releases. [*In re ZZZZ Best Secur. Litig.* (CD CA 1994) 864 F.Supp. 960, 966-968]

• [6:368.5d] Notwithstanding *Central Bank*, accountants who certify financial statements that contain material errors may be primarily liable when they subsequently learn of the errors but fail to correct or withdraw the statements even though they know investors are relying on the statements. [*Overton v. Todman & Co., CPAs, P.C.* (2nd Cir. 2007) 478 F3d 479, 486-487]

[6:368.5e - 6:368.5f] ***Reserved.***

• [6:368.5g] *Compare:* But investors could not state a primary liability claim against two companies that engaged in an elaborate scheme to supply components to a corporation in return for advertising space. Although the scheme inflated the corporation's revenue on its financial statements filed with the SEC and reported to the public, the companies made no statements to the investors (or the public), and the investors *did not rely* upon the companies' deceptive conduct (*see* ¶ *6:372.5*). At most, the companies were aiders and abettors, liability for which was barred by *Central Bank*. [*Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (2008) 552 US 148, 159-164, 128 S.Ct. 761, 770-772]

b) [6:368.6] **No conspiracy liability:** The *Central Bank* rationale—that only conduct expressly proscribed by SEA § 10 can be actionable—precludes a private right of action under SEA § 10(b) and SEC Rule 10b-5 for *conspiracy*. [*In re GlenFed, Inc. Secur. Litig.* (9th Cir. 1995) 60 F3d 591, 592; *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin* (2nd Cir. 1998) 135 F3d 837, 841-843]

c) [6:368.7] **Vicarious liability?** It is not clear whether other *nonstatutory* liability theories frequently used by federal courts to impose SEC Rule 10b-5 liability—notably, *respondeat superior* (¶ *6:368.3b*)—remain viable in light of *Central Bank* and *In re GlenFed, Inc. Secur. Litig.* (¶ *6:368.4 ff.*).

The better-reasoned view is that *Central Bank* did not eliminate respondeat superior liability. [*Seolas v. Bilzerian* (D UT 1997) 951 F.Supp. 978, 981-984—*Central Bank* did not eliminate SEC Rule 10b-5 respondeat superior liability; also see *American Tel. & Tel. Co. v. Winback & Conserve Program, Inc.* (3rd Cir. 1994) 42 F3d 1421, 1429-1432—*Central Bank* did not eliminate common law respondeat superior liability in unfair competition action; *Suez Equity Investors, L.P. v. Toronto-Dominion Bank* (2nd Cir. 2001) 250 F3d 87, 101—"*Central Bank* did not eliminate *primary* liability for business entities … A corporation can only act through its employees and agents" (emphasis in original); compare *In re Prudential Ins. Co. of America Sales Practices Litig.* (D NJ 1996) 975 F.Supp. 584, 612-613—SEA § 20(a) "control person" is "sole source of secondary liability" after *Central Bank*]

d) [6:368.8] **Compare—SEC actions:** An aider and abettor—i.e., any person who "knowingly or recklessly provides substantial assistance" to another in violation of SEC Rule 10b-5—may be enjoined from committing future violations and liable for civil penalties in an action brought by the SEC under SEA § 21(d) (*see* ¶ *6:374.1 ff.*). [SEA §§ 20(e), 21(d) (15 USC §§ 78t(e), 78u(d)); *Janus Capital Group, Inc. v. First Derivative Traders* (2011) 564 US 135, 143, 131 S.Ct. 2296, 2302; *SEC v. Fehn* (9th Cir. 1996) 97 F3d 1276, 1282-1284]

(d) [6:368.9] **Basic elements of Rule 10b-5 claim:** To plead a securities fraud claim under SEA § 10(b) and SEC Rule 10b-5, a plaintiff must allege the following elements:

• A material misrepresentation or omission (¶ 6:369 ff.);

• Scienter (¶ 6:371 ff.);

• A connection between the misrepresentation or omission and the purchase or sale of a security (¶ 6:372.8 ff.);

• Reliance (¶ 6:372.5 ff.);

• Economic loss (¶ 6:373n, 6:373.1 ff.); and

• Loss causation (¶ 6:373d ff.). [*Nguyen v. Endologix, Inc.* (9th Cir. 2020) 962 F3d 405, 413 (internal quotes and citation omitted)]

1) [6:368.10] **Heightened pleading requirements:** Securities fraud claims are subject to heightened pleading requirements, which apply to each element of a securities fraud claim. [*Nguyen v. Endologix, Inc.* (9th Cir. 2020) 962 F3d 405, 414; *Grigsby v. BofI Holding, Inc.* (9th Cir. 2020) 979 F3d 1198, 1206]

a) [6:368.11] **FRCP 9(b):**Federal Rule of Civil Procedure 9(b) requires a plaintiff to "state with particularity the circumstances constituting the fraud." [*Schueneman v. Arena Pharmaceuticals, Inc.* (9th Cir. 2016) 840 F3d 698, 705; *see* ¶ *6:373p*]

b) [6:368.12] **Private Securities Litigation Reform Act (PSLRA):** Under the PSLRA, a securities fraud complaint must: (i) specify each allegedly misleading statement; (ii) specify the reasons why the statement is misleading; and (iii) if an allegation about the statement or omission is made on information and belief, the complaint must state with particularity all facts on which the belief is based. [SEA § 21D(b)(1) (15 USC § 78u-4(b)(1))]

Additionally, for each act or omission that allegedly violated SEA § 10b and SEC Rule 10b-5, the plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required statement of mind." [SEA § 21D(b)(2)(A) (15 USC § 78u-4(b)(2)(A)); *see*¶ 6:371 ff.]

(e) [6:369] **Requirement of "materiality":** Liability under SEC Rule 10b-5 is imposed only where defendant traded on the basis of "material" inside information. The general test of "materiality" is a substantial likelihood that disclosure of the information would be viewed by a *reasonable investor* (*objective* standard) as significantly altering the "total mix" of information. More precisely, information is "material" if a reasonable person would attach significance to the information in making an investment decision—i.e., whether the information would reasonably and objectively affect the value of the securities or the decision to purchase or sell. [*Matrixx Initiatives, Inc. v. Siracusano* (2011) 563 US 27, 38-39, 131 S.Ct. 1309, 1318; *Amgen Inc. v.Connecticut Retirement Plans & Trust Funds* (2013) 568 US 455, 459-469, 133 S.Ct. 1184, 1191-1197—proof of "materiality" not a prerequisite to class certification in class action; *Khoja v. Orexigen Therapeutics, Inc.* (9th Cir. 2018) 899 F3d 988, 1009—information is material "if there is a substantial likelihood that a reasonable investor would have acted differently if the misrepresentation had not been made or the truth had been disclosed"; compare *Retail Wholesale & Dept. Store Union Local 338 Retirement Fund v. Hewlett-Packard Co.* (9th Cir. 2017) 845 F3d 1268, 1277-1278—CEO's violation of corporate ethics code (CEO lied about intimate relationship with independent contractor and falsified expense reports to cover up relationship) not material even though it led to his resignation which prompted decline in stock price]

1) [6:369.1] **"Materiality" although no immediate market reaction:** In large, publicly-held companies having actively-traded stock, the release of material information usually has an immediate impact on stock price. But information may be "material" even though the market does not react immediately. Markets are not perfect, and stock prices are affected by many factors that frequently have a *cumulative* effect on what information is deemed "material." [*No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.* (9th Cir. 2003) 320 F3d 920, 934 (rejecting "bright-line" rule of *Oran v. Stafford* (3rd Cir. 2000) 226 F3d 275, 282, that information not producing immediate market reaction is immaterial as matter of law); *United States v. Jenkins* (9th Cir. 2011) 633 F3d 788, 802]

➪ [6:370] ***PRACTICE POINTER:*** Again, prudence dictates caution. If in doubt whether a person is an "insider" or whether the information about the business is "material," the safe course is to refrain from trading or tipping others until the information is disclosed publicly.

If the information was enough to cause one to buy or sell, it's hard to argue later it wasn't material.

2) [6:370a] **When duty to disclose arises:** As discussed (*¶ 6:360 ff.*), nondisclosure of material information in connection with the purchase or sale of securities may violate SEC Rule 10b-5. However, corporations do not have a duty to disclose facts simply because they are material. "§ 10(b) and Rule 10b-5 do not create an affirmative duty to disclose any and all material information … merely because a reasonable investor would very much like to know that information." [*In re Vivendi, S.A. Secur. Litig.* (2nd Cir. 2016) 838 F3d 223, 239; see *Matrixx Initiatives, Inc. v. Siracusano* (2011) 563 US 27, 44-45, 131 S.Ct. 1309, 1321-1322; *Police Retirement System of St. Louis v. Intuitive Surgical, Inc.* (9th Cir. 2014) 759 F3d 1051, 1061—"We have expressly declined to require a rule of completeness for securities disclosures because no matter how detailed and accurate disclosure statements are, there are likely to be additional details that could have been disclosed but were not" (brackets and internal quotes omitted)]

A duty to disclose material facts arises only when (i) a corporate insider trades (or tips others to trade) on the information, (ii) a statute or regulation affirmatively requires disclosure, *or* (iii) the corporation has made (or allowed) inaccurate, incomplete or misleading *prior disclosures*. [See *Williams v. Globus Med., Inc.* (3rd Cir. 2017) 869 F3d 235, 241; *In re Omnicare, Inc. Secur. Litig.* (6th Cir. 2014) 769 F3d 455, 471; and *In re Nvidia Corp. Secur. Litig.* (9th Cir. 2014) 768 F3d 1046, 1056-1057; *Gray v. First Winthrop Corp.* (9th Cir. 1996) 82 F3d 877, 885—issuer has continuing duty to disclose material information received prior to close of offering]

Rule 10b-5 does not apply to pure omissions (i.e., "when a speaker says nothing, in circumstances that do not give any particular meaning to that silence"). Rather, it "requires disclosure of information necessary to ensure that *statements already made* are clear and complete." [*Macquarie Infrastructure Corp. v. Moab Partners, L.P.* (2024) 601 U.S. 257, 264, 144 S.Ct. 885, 891 (emphasis added)]

Thus, the Rule "covers half-truths, not pure omissions. Logically and by its plain text, the Rule requires identifying affirmative assertions (*i.e.*, 'statements made') before determining if other facts are needed to make those statements 'not misleading.'" [*Macquarie Infrastructure Corp. v. Moab Partners, L.P., supra,* 601 US at 264, 144 S.Ct. at 891]

a) [6:370b] **Duty to update:** Clearly, corporations have a duty to update (correct) disclosures that were misleading when made (¶ 6:370a). But corporations are also bound to correct any voluntary disclosures that, although correct when made, *become materially misleading in light of subsequent events*. [See *In re Time Warner Inc. Secur. Litig.* (2nd Cir. 1993) 9 F3d 259, 267-268; *Backman v. Polaroid Corp.* (1st Cir. 1990) 910 F2d 10, 16-17; compare *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Companies, Inc.* (2nd Cir. 1996) 75 F3d 801, 808-811—company's abrupt price cuts that departed from previously disclosed marketing plan involving periodic price *increases* not materially misleading when viewed in context of total information disclosed to investors; *Reese v. BP Exploration (Alaska) Inc.* (9th Cir. 2011) 643 F3d 681, 691-694—provision in contract included in SEC filing stating that corporation would operate oil pipeline in accordance with "good oil and gas field practices" did not constitute actionable securities fraud when subsequent pipeline break caused major oil spill]

The duty to update, however, does *not* mean companies have to provide an immediate update on every internal development, especially when it involves product development. [*Weston Family Partnership LLLP v. Twitter, Inc.* (9th Cir. 2022) 29 F4th 611, 620-621—company did not have to disclose immediately "software bugs" that affected product's development (company's prior statements about product's development were "qualified and vague")]

b) [6:370c] **Forecasts and opinions:** Corporations have no duty to provide forecasts (of sales, revenues, growth, etc.). However, forecasts, as well as other statements of opinion (e.g., a new product will represent a "major change" over existing products), may be regarded as "facts" under SEC Rule 10b-5. As such, they must have a *reasonable basis in fact* and be *sincerely believed true*. [See *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Tech., Inc.* (9th Cir. 2017) 856 F3d 605, 616; *In re Oracle Corp. Secur. Litig.* (9th Cir. 2010) 627 F3d 376, 388; *In re Lyondell Petrochemical Co. Secur. Litig.* (9th Cir. 1993) 984 F2d 1050, 1052-1053; *see also ¶ 5:58.2;* compare *Oregon Pub. Employees Retirement Fund v. Apollo Group Inc.* (9th Cir. 2014) 774 F3d 598, 606—mildly optimistic expressions of opinion such as "good" or "well-regarded" ("feel-good monikers") constitute inherently subjective and nonactionable "puffing"; *Macomb County Employees' Retirement System v. Align Tech., Inc.* (9th Cir. 2022) 39 F4th 1092, 1099—senior executives' "vague, generically positive terms" describing corporation's performance in China constituted nonactionable "puffery"]

"Forward-looking" statements must be analyzed in the context of the *total mix of information* provided to investors. Cautionary language may negate the materiality of alleged misrepresentations or omissions (the "bespeaks caution" doctrine). Where forecasts and opinions are accompanied by *specific and meaningful cautionary statements*, any misrepresentations or omissions therein are *immaterial*. [*In re Worlds of Wonder Secur. Litig.* (9th Cir. 1994) 35 F3d 1407, 1413-1415; see *Provenz v. Miller* (9th Cir. 1996) 102 F3d 1478, 1487; compare *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.* (9th Cir. 2005) 416 F3d 940, 947-948—misrepresentation of *present or historical facts* cannot be cured by cautionary language]

As with other voluntary disclosures (¶ 6:370b), corporations must update and correct their forecasts when subsequent events indicate the forecasts have become materially false or misleading. [See *Weiner v. Quaker Oats Co.* (3rd Cir. 1997) 129 F3d 310, 317-318; *Marx v. Computer Sciences Corp.* (9th Cir. 1974) 507 F2d 485, 489-492; *In re Adobe Systems, Inc. Secur. Litig.* (ND CA 1991) 767 F.Supp. 1023, 1029]

1/ [6:370d] **Mere risk of failure need not be disclosed:** Predictions are inherently uncertain. "The law does not require public disclosure of mere *risks* of failure. No prediction—even a prediction that the sun will rise tomorrow—has a 100 percent probability of being correct … If a mistaken prediction is deemed a fraud, there will be few predictions, including ones that are well grounded, as no one wants to be held hostage to an unknown future." [*City of Livonia Employees' Retirement System v. Boeing Co.* (7th Cir. 2013) 711 F3d 754, 758 (emphasis in original)—Boeing's failed forecast of new Dreamliner's initial flight date not fraudulent despite engineering tests that indicated possible problems]

2/ [6:370e] **"Safe harbor" for publicly-held companies:** Section 21E precludes liability arising from "forward-looking statements" (i.e., forecasts, projections, etc.) accompanied by "meaningful cautionary statements" and made by or on behalf of 1934 Act reporting companies. [SEA § 21E (15 USC § 78u-5); see *Weston Family Partnership LLLP v. Twitter, Inc.* (9th Cir. 2022) 29 F4th 611, 623—forward-looking statements in shareholder letter and 10-Q fell within safe harbor because they "were accompanied by very detailed meaningful cautionary language" that identified factors that could cause actual results to differ; *Police Retirement System of St. Louis v. Intuitive Surgical, Inc.* (9th Cir. 2014) 759 F3d 1051, 1058—"An earnings projection is by definition a forward-looking statement" (brackets and internal quotes omitted); *Lormand v. US Unwired, Inc.* (5th Cir. 2009) 565 F3d 228, 244-245—boilerplate, generic or formulaic cautionary statements are not "meaningful cautionary statements"; see also SA § 27A (15 USC § 77z-2) for similar "safe harbor" re 1933 Act claims]

Under § 21E, "if a statement is accompanied by 'meaningful cautionary language,' the defendants' state of mind is *irrelevant*." [*Harris v. Ivax Corp.* (11th Cir. 1999) 182 F3d 799, 803 (emphasis added); *In re Cutera Secur. Litig.* (9th Cir. 2010) 610 F3d 1103, 1111-1113]

Compare—"mixed" statements: The safe harbor does not apply to non-forward-looking statements that are combined with forward-looking statements. "The mere fact that a statement contains some reference to a projection of future events cannot sensibly bring the statement within the safe harbor if the allegation of falsehood relates to non-forward-looking aspects of the statement." [*In re Quality Systems, Inc. Secur. Litig.* (9th Cir. 2017) 865 F3d 1130, 1141-1142; see *Dougherty v. Esperion Therapeutics, Inc.* (6th Cir. 2018) 905 F3d 971, 984]

[6:370f - 6:370i] ***Reserved.***

c) [6:370j] **Matters of common knowledge:** The disclosure requirement generally applies to information uniquely within the corporation's knowledge. There is no duty to disclose matters that are generally *known or "knowable"* by the investing public. Reason: It is pointless and costly to compel firms to reprint information already in the public domain. [*Hanon v. Dataproducts Corp.* (9th Cir. 1992) 976 F2d 497, 505—obvious to financial market that success of computer developed to combine airline tickets and boarding passes required airlines to adopt standardized documents; *Epstein v. Washington Energy Co.* (9th Cir. 1996) 83 F3d 1136, 1140-1142—public utility need not describe possibility that regulators might deny requested rate increase]

d) [6:370k] **Third-party statements and forecasts:** Companies are not required to police statements made by third parties (such as journalists and financial analysts) for inaccuracies, even where the third party attributes the statements to the company. To impose liability for third party statements or forecasts, plaintiff must demonstrate

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(i) an "insider" adopted the statement, and (ii) the "insider" knew the forecast was unreasonable when made but failed to disclose its unreasonableness to investors. [*Raab v. General Physics Corp.* (4th Cir. 1993) 4 F3d 286, 288; *In re Time Warner Inc. Secur. Litig.* (2nd Cir. 1993) 9 F3d 259, 264-265; see *In re Syntex Corp. Secur. Litig.* (9th Cir. 1996) 95 F3d 922, 934; *In re Stac Electronics Secur. Litig.* (9th Cir. 1996) 89 F3d 1399, 1410]

1/ [6:370*l*] **Compare—misleading information deliberately supplied by company officials:** Inaccurate reports by securities analysts and the press may be attributable to misleading information *deliberately supplied by company officials*. In such circumstances, a company "cannot escape liability simply because it carried out its alleged fraud through the public statements of third parties." [*Warshaw v. Xoma Corp.* (9th Cir. 1996) 74 F3d 955, 959; *Cooper v. Pickett* (9th Cir. 1997) 137 F3d 616, 624; see *Southland Secur. Corp. v. INSpire Ins. Solutions Inc.* (5th Cir. 2004) 365 F3d 353, 373-383]

2/ [6:370m] **Accurate promotional statements—no duty to disclose payment by corporation:** A corporation may lawfully engage third parties to promote the corporation's stock through boastful but truthful articles. "It may seem odd to the uninitiated, but nothing in the securities laws bars the issuer of a regulated security from paying an analyst for a stock recommendation." While SA § 17(b) requires the *recipient* to disclose the payment in all circumstances, the corporation is not per se required to make such disclosure to the market or to its investors. [*In re Galectin Therapeutics, Inc. Secur. Litig.* (11th Cir. 2016) 843 F3d 1257, 1273 (internal quotes omitted); see SA § 17(b) (15 USC § 77q(b))]

e) [6:370n] **Materialized risks and contingencies:** Risk disclosures can be misleading if they warn about risks that "could" or "may" occur when the corporation knows that the risks have already materialized. [*In re Alphabet, Inc. Secur. Litig.* (9th Cir. 2021) 1 F4th 687, 703-704—risk disclosures warning about security vulnerabilities were misleading because corporation failed to disclose that it already detected cybersecurity issues; see *Siracusano v. Matrixx Initiatives, Inc.* (9th Cir. 2009) 585 F3d 1167, 1181—company warned about "risks of product liability claims in the abstract" when high-level executives knew that company's product was linked to medical condition and that company was going to be sued; *Berson v. Applied Signal Tech., Inc.* (9th Cir. 2008) 527 F3d 982, 985-987—company's statement that it anticipated revenue from backlogged work was misleading because it failed to disclose risks that "may already have come to fruition" (backlog included "substantially delayed" work that was "at serious risk of being cancelled altogether")]

3) [6:370.1] **"Materiality" of merger negotiations and other pending transactions:** It is not completely clear when *evolving* developments and *pending* transactions—e.g., new product discoveries or merger negotiations—become "material" under the above disclosure rules (¶ 6:370a ff.).

a) [6:370.2] **Disclosure to outside shareholders:** The "materiality" of premerger negotiations under the federal securities laws must be determined on a case-by-case basis using a "probability/magnitude approach"—i.e., by considering the *probability* that the transaction will be consummated and its *importance* to the company. [*Basic Inc. v. Levinson* (1988) 485 US 224, 238-239, 108 S.Ct. 978, 987—rejecting majority view among circuits that there is no duty to disclose until agreement in principle reached]

In contrast, there ordinarily is no duty under *California* law to disclose preliminary negotiations until an agreement in principle is reached. [*Eldridge v. Tymshare, Inc.* (1986) 186 CA3d 767, 775, 230 CR 815, 819—publicly held corporation had no duty under California law to disclose resumption of merger negotiations before agreement in principle reached]

b) [6:370.3] **Corporate repurchases from employees:** A corporation has a duty to disclose the status of merger negotiations to an employee-shareholder from whom it repurchases stock even though no agreement has been reached on price or structure. This duty applies to both public and closely-held corporations.

Rationale: Such preliminary merger discussions are "material" to the employee's decision to sell their shares; and disclosure to the employee would not undermine the corporation's merger effort. [*McCormick v. Fund American Companies, Inc.* (9th Cir. 1994) 26 F3d 869, 875-876 (publicly-traded corporation); *Jordan v. Duff & Phelps, Inc.* (7th Cir. 1987) 815 F2d 429, 434-439 (closely-held corporation); *Smith v. Duff & Phelps, Inc.* (11th Cir. 1990) 891 F2d 1567, 1572-1574 (closely-held corporation)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

➪ [6:370.3a] ***PRACTICE POINTER:*** Carefully consider the corporation's disclosure obligations when it repurchases an employee's stock under circumstances where the employee has a choice whether to sell (i.e., is making an "investment decision"). Be sure all *material* information is fully disclosed.

c) [6:370.4] **Compare—misleading statements:** Of course, whether or not there is a duty to disclose, no corporation (public or closely held) may make false or misleading statements about merger negotiations—e.g., falsely *denying* there are any pending discussions. [See *Basic Inc. v. Levinson* (1988) 485 US 224, 233, 108 S.Ct. 978, 984; *Clay v. Riverwood Int'l Corp.* (11th Cir. 1998) 157 F3d 1259, 1268-1269, vacated in part (11th Cir. 1999) 176 F3d 1381—corporation's vague press release that it was reviewing "strategic alternatives" including "possible sale or merger" not rendered misleading (i.e., no duty to update) when field of potential buyers narrowed to one]

d) [6:370.5] **Compare—silence:** But where nondisclosure of merger negotiations is in no way *misleading*—e.g., "no comment" or "I neither confirm nor deny"—there can be no "fraud" or "deception." As discussed above (¶ *6:370a*), SEC Rule 10b-5 imposes a duty to disclose only when silence would make other, previously-made statements false or misleading (or an insider is trading on the information). [See *Basic Inc. v. Levinson* (1988) 485 US 224, 239, 108 S.Ct. 978, 987, fn. 17; see also *Glazer v. Formica Corp.* (2nd Cir. 1992) 964 F2d 149, 155-156—fact pending buy-out talks became material does not itself give rise to duty to disclose; compare *Weiner v. Quaker Oats Co.* (3rd Cir. 1997) 129 F3d 310, 316-318—corporation had duty to update forecasts made misleading by impending merger (¶ *6:370c*)]

(f) [6:371] **Scienter required:** To establish liability under SEA § 10b and SEC Rule 10b-5, a private plaintiff must prove that the defendant acted with scienter—some intent to deceive, manipulate or defraud. [*Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (2007) 551 US 308, 319, 127 S.Ct. 2499, 2507 (internal quotes and citation omitted)]

To satisfy this element, a plaintiff must allege that the defendant "made false or misleading statements either intentionally or with deliberate recklessness" (¶ 6:371.1). [*Nguyen v. Endologix, Inc.* (9th Cir. 2020) 962 F3d 405, 414 (internal quotes and citations omitted)]

1) [6:371a] **Negligence insufficient:** Plaintiff cannot recover damages (nor can the SEC obtain injunctive relief) in a SEC Rule 10b-5 action if defendant's conduct was merely negligent, or even grossly negligent. [*Ernst & Ernst v. Hochfelder* (1976) 425 US 185, 201-202, 96 S.Ct. 1375, 1385; *Aaron v. SEC* (1980) 446 US 680, 691, 100 S.Ct. 1945, 1952-1953; see *DSAM Global Value Fund v. Altris Software, Inc.* (9th Cir. 2002) 288 F3d 385, 387—"seriously botched audit" ("a compelling case of negligence—perhaps even gross negligence") not actionable under 10b-5]

2) [6:371.1] **Recklessness may qualify:** The scienter element in a SEC Rule 10b-5 action may be satisfied by "*deliberate recklessness*"—i.e., *highly unreasonable misconduct* representing an *extreme departure from the standards of ordinary care* and presenting a danger of misleading buyers or sellers that is either *known* to defendant or is *so obvious* that defendant *must have been aware of it*. [*Hollinger v. Titan Capital Corp.* (9th Cir. 1990) 914 F2d 1564, 1569 (en banc); *In re Quality Systems, Inc. Secur. Litig.* (9th Cir. 2017) 865 F3d 1130, 1144; *Schueneman v. Arena Pharmaceuticals, Inc.* (9th Cir. 2016) 840 F3d 698, 705; *In re Nvidia Corp. Secur. Litig.* (9th Cir. 2014) 768 F3d 1046, 1053]

3) [6:371.2] **Gross unfairness inadequate:** The fact that a securities transaction may be grossly unfair is not enough by itself to establish liability under SEC Rule 10b-5. If there is adequate disclosure and no deception, there is no basis for a 10b-5 challenge. [*Santa Fe Indus., Inc. v. Green* (1977) 430 US 462, 474-477, 97 S.Ct. 1292, 1301-1303—short-form merger of 90%-owned subsidiary into parent not actionable under 10b-5 despite "low-ball" valuation of minority shareholders' stock]

4) [6:371.2a] **Officer's scienter imputed to corporation; "adverse interest" exception inapplicable:** SEC Rule 10b-5 borrows from the common law respondeat superior doctrine by imputing an officer's scienter to the corporation where the officer acted with apparent corporate authority. This is so even where the officer's actions were *adverse to the corporation*, as where the officer defrauded or stole from the corporation. The "adverse interest" exception to respondeat superior liability (rogue agent's actions or knowledge not imputed to the principal where agent acts for agent's own purpose adversely to the principal) does *not* apply against *innocent third parties*, such as the corporation's *shareholders*. [*In re ChinaCast Ed. Corp. Secur. Litig.* (9th Cir. 2015) 809 F3d 471, 475-479—corporate founder/CEO looted publicly held corporation into insolvency and then falsely reported to investors corporation was financially sound]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

5) [6:371.3] **"Collective" or "imputed" scienter:** Where a corporation and individual insiders are accused of violating SEC Rule 10b-5, scienter may be imputed to the *individual* defendants "in some situations, for example, where we find that a company's public statements are so important and so dramatically false that they would create a strong inference that at least *some* corporate officials knew of the falsity upon publication." Similarly, even when no single director or officer possessed scienter, the *cumulative or collective knowledge* of the corporate insiders may demonstrate an intent to deceive, manipulate or defraud that may be *imputed* to the *corporation* (also referred to as "corporate scienter"). However, the Ninth Circuit cases that have discussed "collective" or "imputed" scienter appeared loath to adopt it, and no Ninth Circuit case has actually found scienter on this theory. [See *Oregon Pub. Employees Retirement Fund v. Apollo Group Inc.* (9th Cir. 2014) 774 F3d 598, 607-608 (emphasis in original; brackets and internal quotes omitted); *In re Nvidia Corp. Secur. Litig.* (9th Cir. 2014) 768 F3d 1046, 1063; *Glazer Capital Mgmt., LP v. Magistri* (9th Cir. 2008) 549 F3d 736, 744-745; *see also* ¶ *6:371.7b*]

Comment: The rejection of "group pleading" (¶ *6:371.7a*) would appear to cast further doubt on this theory.

[6:371.4 - 6:371.5] ***Reserved.***

6) [6:371.6] **Pleading standards; "strong inference" test:** A complaint must "state with particularity facts giving rise to a *strong inference*" defendant acted with scienter. [SEA § 21D(b)(2)(A) (15 USC § 78u-4(b)(2)(A)) (emphasis added)]

A "strong inference" is "more than merely 'reasonable' or 'permissible'—it must be *cogent and compelling*" in comparison with other explanations for the defendant's conduct. A complaint will survive a motion to dismiss "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." [*Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (2007) 551 US 308, 323-324, 127 S.Ct. 2499, 2510 (emphasis added); see *Prodanova v. H.C. Wainwright & Co., LLC* (9th Cir. 2021) 993 F3d 1097, 1107-1108—plaintiff failed to plead scienter because no plausible financial incentive for investment bank to publish analyst's report that set $7/share target price just before bank announced it was placing agent for $6/share dilutive offering (bank's "conduct is more like an embarrassing Red Sox error than an elaborate Black Sox fraud")]

a) [6:371.6a] **General pleading rules apply:** While plaintiffs must satisfy a heightened pleading standard to bring a securities fraud claim (¶ 6:368.10 ff.), general "non-fraud" pleading rules also apply:

1/ [6:371.6b] **Factual allegations accepted as true:** When faced with a motion to dismiss, the court must accept all well-pleaded factual allegations in the complaint as true. [*Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (2007) 551 US 308, 322, 127 S.Ct. 2499, 2509]

2/ [6:371.6c] **All facts considered:** The court must consider the complaint *in its entirety*, as well as other sources ordinarily examined when ruling on a motion to dismiss—in particular, documents incorporated into the complaint by reference and matters of which a court may take judicial notice. The inquiry is whether *all* of the alleged facts, taken collectively, give rise to a strong inference of scienter, rather than whether any individual allegation meets that standard. [*Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (2007) 551 US 308, 322-323, 127 S.Ct. 2499, 2509; see *Webb v. SolarCity Corp.* (9th Cir. 2018) 884 F3d 844, 855-856; *In re VeriFone Holdings, Inc. Secur. Litig.* (9th Cir. 2012) 704 F3d 694, 697, 701-703]

b) [6:371.6d] **Plausible nonfraudulent explanations:** In determining whether a plaintiff sufficiently pleaded a "strong inference" of scienter, a court must take into account *plausible opposing inferences*—i.e., plausible nonculpable explanations for defendant's conduct. [*Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (2007) 551 US 308, 323, 127 S.Ct. 2499, 2509-2510; see *Matrixx Initiatives, Inc. v. Siracusano* (2011) 563 US 27, 48, 131 S.Ct. 1309, 1324; *ESG Capital Partners, LP v. Stratos* (9th Cir. 2016) 828 F3d 1023, 1033—"[T]he fraudulent inference need not be more compelling than its nonfraudulent alternatives; if two possible inferences—one fraudulent and the other nonfraudulent—are equally compelling, a plaintiff has demonstrated a strong inference of scienter"]

1/ [6:371.6e] **Application—statements about regulatory approval:** Plaintiff's allegations that a medical device company made knowingly false statements about the likelihood of the FDA approving its product after it experienced "unresolvable" problems in Europe did not satisfy the "strong inference" test. Without any factual allegations that the company had sought to profit from the alleged scheme before the "unsolvable" problems were

revealed, plaintiff's theory that "a company would promise FDA approval that it knew would not materialize" was not plausible. Accordingly, plaintiff's putative securities fraud class action was dismissed (without leave to amend) for failing to plead that the defendant acted with scienter. [*Nguyen v. Endologix, Inc.* (9th Cir. 2020) 962 F3d 405, 414-416]

c) [6:371.7] **Compare—proving scienter at trial:** At trial, plaintiff must prove their case by a *preponderance of the evidence*—i.e., plaintiff must demonstrate it is *more likely than not* that defendant acted with scienter. [*Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (2007) 551 US 308, 328-329, 127 S.Ct. 2499, 2513]

d) [6:371.7a] **Corporate documents prepared by multiple defendants—"group pleading" rejected:** Scienter must be pleaded "with particularity" as to *each* defendant. Where the alleged fraud is contained in documents reflecting the input of several persons (e.g., prospectuses, annual reports), plaintiffs may not simply attribute the fraudulent statements to various corporate personnel according to their titles or positions in the company ("group pleading"). Rather, plaintiffs must "distinguish among those they sue and enlighten *each defendant* as to their particular part in the alleged fraud." [*Southland Secur. Corp. v. INSpire Ins. Solutions Inc.* (5th Cir. 2004) 365 F3d 353, 364-365 (emphasis in original)—"group pleading" doctrine set forth in *Wool v. Tandem Computers Inc*. (9th Cir. 1987) 818 F2d 1433 did not survive 1995 enactment of SEA § 21D(b); *Allison v. Brooktree Corp.* (SD CA 1998) 999 F.Supp. 1342, 1350]

Corporate documents may nonetheless be charged to individual corporate officers if *specific facts link the individual to the statement at issue*—e.g., a signature on a document or the individual's involvement in formulation of the document or the portion thereof containing the statement. (Of course, the *corporation* may be treated as the author of statements issued by authorized officers acting on its behalf or otherwise to further corporate interests.) [*Southland Secur. Corp. v. INSpire Ins. Solutions Inc*., supra, 365 F3d at 365-367; see *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.* (2nd Cir. 2008) 531 F3d 190, 195-196]

1/ [6:371.7b] **Compare—"core operations" doctrine:** A strong inference that *key officers* possessed scienter may arise, either alone or in conjunction with other facts and circumstances, where a misrepresentation or omission concerned a company's "core operations" or an important transaction *that the officers were certain to know*. However, "[p]roof under this theory is not easy": Plaintiff must produce specific admissions of *detailed involvement in the minutia of a company's operations*, such as data monitoring, or, alternatively, witness accounts demonstrating that executives had *actual involvement in creating false reports*. [See *Webb v. SolarCity Corp.* (9th Cir. 2018) 884 F3d 844, 854, 857 (but finding plaintiff's allegations failed to produce strong inference of scienter under "core operations" theory); *In re Nvidia Corp. Secur. Litig.* (9th Cir. 2014) 768 F3d 1046, 1063-1064 (same); *Police Retirement System of St. Louis v. Intuitive Surgical, Inc.* (9th Cir. 2014) 759 F3d 1051, 1062-1063 (same); *see also* ¶ *6:371.3*]

e) [6:371.8] **"Suspicious" insider trading as evidence of scienter:** Insider trading in large amounts at extremely opportune times (e.g., just before release of materially adverse information) can indicate scienter. On the other hand, credible and wholly innocent explanations for stock sales—such as long-standing programs of periodic divestment, need for cash to meet tax liabilities, etc.—can rebut an inference of bad faith. To support a "strong inference" of scienter (¶ 6:371.6 ff.), the pleading must show insider trading "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed insider information." [*Curry v. Yelp Inc.* (9th Cir. 2017) 875 F3d 1219, 1226; *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Tech., Inc.* (9th Cir. 2017) 856 F3d 605, 621; *Zucco Partners, LLC v. Digimarc Corp.* (9th Cir. 2009) 552 F3d 981, 1005-1006]

f) [6:371.9] **Discovery stayed pending dismissal motion:** All discovery during the pendency of a motion to dismiss is stayed (except where necessary to preserve evidence or otherwise prevent undue prejudice to a litigant). [SEA § 21D(b)(3) (15 USC § 78u-4(b)(3))]

The purpose of the stay is to prevent securities fraud plaintiffs from burdening defendants with expensive discovery to uncover facts that should have been contained in the complaint. Therefore, except as permitted by § 21D(b), discovery may be conducted "*only after the court has sustained the legal sufficiency of the complaint*." [*SG Cowen Secur. Corp. v. United States Dist. Ct. for Northern Dist. of Calif.* (9th Cir. 1999) 189 F3d 909, 911-913 (emphasis in original)—court may not grant request to conduct discovery following dismissal

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

with leave to amend; see *Petrie v. Electronic Game Card, Inc.* (9th Cir. 2014) 761 F3d 959, 970—materials obtained by plaintiff through discovery when no stay was in effect may be used to prepare amended complaint; see SEA § 21D(b) (15 USC § 78u-4(b))]

(g) [6:372] **Who may sue:** Damages suits for SEC Rule 10b-5 violations may be brought only by (i) the SEC or (ii) actual *defrauded purchasers or sellers* (including private options traders). Thus, 10b-5 actions *cannot* be brought by would-be sellers or purchasers. [*Blue Chip Stamps v. Manor Drug Stores* (1975) 421 US 723, 754-755, 95 S.Ct. 1917, 1934; *Fry v. UAL Corp.* (7th Cir. 1996) 84 F3d 936, 938-939; see *Neubronner v. Milken* (9th Cir. 1993) 6 F3d 666, 669-670 (*discussed at*¶ *6:373a*)]

1) [6:372.1] **Aborted contract purchasers or sellers:** However, persons with contractual rights to purchase or sell securities may also have standing to invoke SEC Rule 10b-5. This is so even though the transaction was never consummated or the rights were contingent upon future events (e.g., specified level of corporate earnings), or even if the securities were never issued. [See *Griggs v. Pace American Group, Inc.* (9th Cir. 1999) 170 F3d 877, 880; and *Sulkow v. Crosstown Apparel Inc.* (2nd Cir. 1986) 807 F2d 33, 36-37]

And, of course, the purchaser of a stock *option* has standing under Rule 10b-5 … because the option itself is a *security* separate and distinct from the underlying stock. [*Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.* (2001) 532 US 588, 593-594, 121 S.Ct. 1776, 1780-1781; see SEA § 3(a)(10) (15 USC § 78c(a)(10)); *and*¶ *5:32.10*]

a) [6:372.1a] **Limitations:** The contractual rights must be enforceable. For example, standing cannot be conferred by:

• An oral stock purchase contract unenforceable under the statute of frauds. [*Kagan v. Edison Brothers Stores, Inc.* (7th Cir. 1990) 907 F2d 690, 691; compare *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.* (2001) 532 US 588, 595-596, 121 S.Ct. 1776, 1781-1782 (oral option enforceable under state law)]

• A subscription for shares where the issuer expressly reserves the right to reject any subscription. [*Cohen v. Stratosphere Corp.* (9th Cir. 1997) 115 F3d 695, 700-702]

Moreover, the contract must be for the purchase or sale of securities as *between* the plaintiff and defendant, not merely an agreement *with others* to buy or sell securities from the defendant. [*Ronzani v. Sanofi S.A.* (2nd Cir. 1990) 899 F2d 195, 198—P and D's "joint offer" to purchase corporation's securities not a purchase or sale *between* them]

And an "aborted" seller does not have standing if merely induced to *retain* securities through defendant's fraud. [See *Lewelling v. First Calif. Co.* (9th Cir. 1977) 564 F2d 1277, 1279]

2) Forced sales

a) [6:372.2] **Securities exchanged or sold due to mergers:** Exchanges of shares or other securities pursuant to mergers or other business combinations generally constitute "purchases and sales" for Rule 10b-5 purposes. [See, e.g., *Vine v. Beneficial Finance Co.* (2nd Cir. 1967) 374 F2d 627, 634-635]

Rationale: Shareholders have only two choices when a merger is approved: (i) exchange their existing securities for the new securities and/or cash offered in the merger; or (ii) sell the securities back to the corporation under dissenters' appraisal rights (*see*¶ *8:292 ff.*). Either way, there is a forced "sale." [See *Securities Investor Protection Corp. v. Vigman* (9th Cir. 1986) 803 F2d 1513, 1518-1519]

1/ [6:372.2a] **Compare—defendant's absolute power to force sale:** If the defendant owns sufficient shares to effect a merger without approval of the other shareholders, any misrepresentation or other "fraud" that may have occurred during the transaction will have had no effect upon the sale. In such circumstances, the absence of causation defeats a SEC Rule 10b-5 claim against the controlling shareholder (*see*¶ *6:372.9*). [*Scattergood v. Perelman* (3rd Cir. 1991) 945 F2d 618, 624-626, relying upon *Virginia Bankshares, Inc. v. Sandberg* (1991) 501 US 1083, 1106-1108, 111 S.Ct. 2749, 2765-2766—minority shareholders whose proxies were superfluous in merger transaction could not state cause of action based on controlling shareholder's alleged violations of proxy rules]

b) [6:372.2b] **Securities exchanged or altered in bankruptcy reorganization:** An exchange, alteration or reduction in a stockholder's securities resulting from an approved plan of reorganization pursuant to a *Chapter 11 bankruptcy* is *not* treated as a forced "sale" for SEC Rule 10b-5 purposes.

Reason: Chapter 11 proceedings are judicially-supervised and grant shareholders numerous procedural and substantive safeguards, including the right to participate in and even shape the plan of reorganization. "Were the forced sale doctrine made applicable to Chapter 11 it is conceivable that nearly every confirmed Chapter 11 reorganization could be converted into a securities fraud suit by understandably unhappy shareholders simply by alleging a predicate of fraud." [*Jacobson v. AEG Capital Corp.* (9th Cir. 1995) 50 F3d 1493, 1502]

3) [6:372.3] **Pledges of securities:** A pledge of securities is ordinarily considered a "sale" under the anti-fraud provisions of the SEA; thus, pledgees have been deemed "purchasers" with standing to maintain a SEC Rule 10b-5 action. [*Madison Consultants v. FDIC* (2nd Cir. 1983) 710 F2d 57, 60-61; see also *Rubin v. United States* (1981) 449 US 424, 429-430, 101 S.Ct. 698, 701; but see *Lincoln Nat'l Bank v. Herber* (7th Cir. 1979) 604 F2d 1038, 1044 (contra)]

4) [6:372.3a] **Trustee's acceptance of securities in lieu of cash:** A "purchase and sale" occurred when a corporation transferred its securities to a trust created to secure the corporation's obligation to indemnify certain corporate directors, officers and key employees. The transfer was in partial satisfaction of the corporation's obligation to make a monetary contribution to the trust. The trustee's acceptance of the securities was tantamount to a cash purchase. [*In re American Continental Corp./Lincoln Sav. & Loan Secur. Litig.* (9th Cir. 1995) 49 F3d 541, 545]

[6:372.3b] ***Reserved.***

5) [6:372.3c] **Shareholder suing for harm to corporation:** A corporation issuing securities may be a defrauded "seller" under SEC Rule 10b-5, and a shareholder may sue *derivatively* to recover damages for any resulting injury. "[A] corporation is injured when it is fraudulently induced into issuing its own securities for less than their fair value because of misappropriation of inside information." [See, e.g., *Frankel v. Slotkin* (2nd Cir. 1993) 984 F2d 1328, 1334 (but dismissing claim for lack of factual evidence)]

Injury may arise where the corporation receives its own securities in return for newly-issued stock, as where debenture holders exercise a conversion feature. In such circumstances, injury is *not* limited to the nonconverting shareholders. "Though a corporation's minority shareholders are also injured by dilution of their interests in the corporation, the corporation itself as seller of its own securities suffers an *independent* injury sufficient to support an action for damages, derivative or otherwise, under § 10(b) and Rule 10b-5." [*Frankel v. Slotkin*, supra, 984 F2d at 1334 (emphasis added)]

6) [6:372.3d] **Purchaser of stock in one corporation affected by fraud in another corporation:** A corporation —and, *a fortiori,* purchasers and sellers of its stock—may be adversely impacted by events in another corporation with which it has a significant business relationship. Nevertheless, material misstatements made by one corporation regarding its stock are actionable under SEC Rule 10b-5 only by purchasers and sellers of that corporation's stock. [*Ontario Pub. Service Employees Union Pension Trust Fund v. Nortel Networks Corp.* (2nd Cir. 2004) 369 F3d 27, 34]

• [6:372.3e] Thus, defendant corporation that issued unduly rosy sales projections for its fiber optic telecommunications products was not liable to persons who, based on the projections, purchased stock of another corporation that was defendant's primary supplier of fiber optic components. Although the projections clearly caused the supplier's stock to soar (before subsequently plummeting), allowing suits by purchasers of the stock of corporations other than defendant would dramatically expand the scope of SEC Rule 10b-5 and lead to an unacceptable level of abusive litigation. [*Ontario Pub. Service Employees Union Pension Trust Fund v. Nortel Networks Corp.* (2nd Cir. 2004) 369 F3d 27, 29, 32-33]

7) [6:372.4] **Actions for injunctive relief:** Although there is some disagreement, the current view is that plaintiffs must be purchasers or sellers of securities to maintain a 10b-5 action for *injunctive relief* (*¶ 6:373.3a*). [See *Mutual Shares Corp. v. Genesco, Inc.* (2nd Cir. 1967) 384 F2d 540, 546-547 (not required); *Hanna Mining Co.v. Norcen Energy Resources Ltd.* (ND OH 1982) 574 F.Supp. 1172, 1198 (not required); *Warner Communications, Inc. v.Murdoch* (D DE 1984) 581 F.Supp. 1482, 1495 (not required); compare *Cartica Mgmt., LLC v. CorpBanca, S.A.* (SD NY 2014) 50 F.Supp.3d 477, 484-492 (required, and concluding that *Blue Chip Stamps v. Manor Drug Stores*

(1975) 421 US 723, 95 S.Ct. 1917, overruled *Mutual Shares*, supra); *Cowin v. Bresler* (DC Cir. 1984) 741 F2d 410, 425 (required)]

8) [6:372.4a] **Compare—common law fraud actions:** Misrepresentations that induce shareholders to hold (i.e., refrain from selling) their stock may be actionable as common law fraud or negligent misrepresentation. *See¶ 5:421a*.

(h) [6:372.5] **Reliance by plaintiff ("transaction causation"):** Plaintiffs in SEC Rule 10b-5 cases must show that defendant's fraud *caused* them to engage in the transaction (i.e., but for the fraud, plaintiffs would not have purchased or sold the securities). To do so, plaintiffs must show reasonable and actual *reliance* on defendant's deceit—at least where it involved *affirmative* misrepresentations or misconduct. [*Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (2008) 552 US 148, 159, 128 S.Ct. 761, 769—"Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the SEA § 10(b) private cause of action" (*discussed further at ¶ 6:368.5g*); *Erica P. John Fund, Inc. v. Halliburton Co.* (2011) 563 US 804, 810, 131 S.Ct. 2179, 2184-2185; see *In re Atossa Genetics Inc. Secur. Litig.* (9th Cir. 2017) 868 F3d 784, 795-796]

1) [6:372.6] **Nondisclosure cases:** For example, reliance has been presumed in *nondisclosure* cases where liability ultimately depended on speculation as to *how plaintiff would have acted had the information been disclosed*. Plaintiff's reliance may be presumed if the omissions were *material* (*¶ 6:369*): i.e., if defendant's omissions were material, it is presumed that a plaintiff who bought or sold securities would not have done so had the information been disclosed. [See *Affiliated Ute Citizens of Utah v. United States* (1972) 406 US 128, 153-154, 92 S.Ct. 1456, 1472; *Smolen v. Deloitte, Haskins & Sells* (9th Cir. 1990) 921 F2d 959, 964; *Waggoner v. Barclays PLC* (2nd Cir. 2017) 875 F3d 79, 93; compare *In re Volkswagen "Clean Diesel" Marketing, Sales Practices, & Products Liability Litig.* (9th Cir. 2021) 2 F4th 1199, 1208-1209—*Affiliated Ute* presumption does not apply where plaintiff's claims are based on affirmative misrepresentations; *Desai v. Deutsche Bank Secur. Ltd.* (9th Cir. 2009) 573 F3d 931, 940-941—reliance presumption inappropriate in cases based on market manipulation]

a) [6:372.6a] **Compare—omissions *and misrepresentations:*** A presumption of reliance is *not* available when plaintiff alleges both omissions *and* misstatements … unless the case can be characterized as one that *primarily* alleges omissions. [*Binder v. Gillespie* (9th Cir. 1999) 184 F3d 1059, 1064; see *Waggoner v. Barclays PLC* (2nd Cir. 2017) 875 F3d 79, 95-97]

2) [6:372.7] **"Fraud on the market":** Reliance may also be presumed where there was a "fraud on the market"—i.e., where the securities' market price was affected by defendant's misstatements or omissions and plaintiff bought or sold in reliance on the "integrity" of the market. [*Basic Inc. v. Levinson* (1988) 485 US 224, 241-247, 108 S.Ct. 978, 989-992] Hence, plaintiff need only show that defendant made a material misrepresentation (i.e., direct proof of reliance is unnecessary). [See *Halliburton Co. v. Erica P. John Fund, Inc*. (2014) 573 US 258, 267-269, 134 S.Ct. 2398, 2407-2408; *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds* (2013) 568 US 455, 461-463, 133 S.Ct. 1184, 1192; *In re Apple Computer Secur. Litig.* (9th Cir. 1989) 886 F2d 1109, 1114-1115; *and ¶ 6:372.8g*]

To invoke the "fraud on the market" presumption, a plaintiff must prove: (i) the alleged misrepresentation was publicly known; (ii) the misrepresentation was material (¶ 6:369 ff.); (iii) the stock traded in an efficient market (¶ 6:372.7a); and (iv) the plaintiff traded the stock between the time the misrepresentation was made and when the truth was revealed. A defendant can rebut the presumption by showing that the alleged misrepresentation did not actually affect the market price or the plaintiff would have bought or sold the stock even if the plaintiff had been aware of the misrepresentation. [*Halliburton Co. v. Erica P. John Fund, Inc.* (2014) 573 US 258, 268-269, 134 S.Ct. 2398, 2408—presumption is rebutted if there is no connection between alleged misrepresentation and price plaintiff paid or received, or plaintiff's decision to trade at fair market value; *Goldman Sachs Group, Inc. v. Arkansas Teacher Retirement System* (2021) 594 US 113, 118, 141 S.Ct. 1951, 1958; *see*¶ 6:372.7j ff.]

Even a sophisticated investor is entitled to the "fraud-on-the-market" presumption of reliance "since differences in sophistication among purchasers have no bearing on the impersonal market." [*Hanon v. Dataproducts Corp.* (9th Cir. 1992) 976 F2d 497, 506; see *Knapp v. Ernst & Whinney* (9th Cir. 1996) 90 F3d 1431, 1436-1437]

(But this presumption may not apply to "short sellers"; see *Zlotnick v. TIE Communications* (3rd Cir. 1988) 836 F2d 818, 821.)

a) [6:372.7a] **Limitation—"efficient market" prerequisite:** The "fraud-on-the-market" presumption of reliance presupposes (and hence is available only where) the security in question is traded in an "efficient market"—i.e.,

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

one in which securities prices quickly and accurately reflect available material information. [*Halliburton Co. v. Erica P. John Fund, Inc*. (2014) 573 US 258, 270-273, 134 S.Ct. 2398, 2409-2410; *Binder v. Gillespie* (9th Cir. 1999) 184 F3d 1059, 1065; see *Desai v. Deutsche Bank Secur. Ltd*. (9th Cir. 2009) 573 F3d 931, 942—plaintiffs could not circumvent "efficient market" prerequisite by alleging reliance should nonetheless be presumed where defendants' manipulative conduct destroyed efficiency of the market]

Courts consider several factors in determining whether the trading market for a particular security is "efficient," including whether:

• The security trades at a high weekly volume;

• Securities analysts follow and report on the security;

• The security has market makers and arbitrageurs;

• The issuer is a 1934 Act reporting company and is eligible to file a Form S-3 registration statement (*see*¶ *5:49*); and

• There are "empirical facts showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price." [*Binder v. Gillespie*, supra—no "fraud-on-the-market" presumption of reliance where investors failed to show over-the-counter market efficiently processed defendants' misrepresentations/omissions; see *Waggoner v. Barclays PLC* (2nd Cir. 2017) 875 F3d 79, 94]

b) [6:372.7b] **No "fraud-on-the-market" presumption in California common law claims:** A cause of action based upon *deceit* or *negligent misrepresentation* (Civ.C. §§ 1709, 1710) requires *actual reliance* upon the misrepresentation. [*Mirkin v. Wasserman* (1993) 5 C4th 1082, 1088, 23 CR2d 101, 103]

Reason: The common law claims lack important safeguards present in SEC Rule 10b-5 actions (i.e., scienter, "purchaser or seller" requirement, relatively short limitations period and prohibition on punitive damages). Also, investors have adequate remedies under state and federal securities laws. Allowing common law plaintiffs to invoke the "fraud-on-the-market" presumption of Rule 10b-5 without also incorporating its limitations would expand potential liability and invite "speculative and harassing" class action lawsuits. [*Mirkin v. Wasserman*, supra, 5 C4th at 1100-1103, 1107-1108, 23 CR2d at 112-113, 117]

c) [6:372.7c] **Compare—"fraud-created-the-market":** The "fraud-on-the-market" theory presupposes an active and well-developed public market for the securities in question. It thus applies mainly to *secondary trades* in securities of established, publicly-held companies. There can be no presumption of reliance where there is no palpable market to rely upon, as where a closely-held corporation "goes public" for the first time. [See *Freeman v. Laventhol & Horwath* (6th Cir. 1990) 915 F2d 193, 197-198—"fraud-on-the-market" theory inapplicable to fraud in primary market for newly-issued bonds]

Nevertheless, some courts have allowed plaintiffs to proceed against first-time issuers on a "fraud-created-the-market" theory—i.e., defendant's fraudulent acts were so pervasive that the securities would never have been successfully marketed had purchasers known the truth. [See *Shores v. Sklar* (5th Cir. 1981) 647 F2d 462, 469 (en banc) (overruled on other grounds as recognized by *Regents of Univ. of Calif. v. Credit Suisse First Boston (USA), Inc.* (5th Cir. 2007) 482 F3d 372, 392 & fn. 38); *T.J. Raney & Sons, Inc. v. Fort Cobb, Okl. Irrig. Fuel Auth.* (10th Cir. 1983) 717 F2d 1330, 1333—*Shores* followed where securities not lawfully issued; but see *Nuveen Municipal High Income Opportunity Fund v. City of Alameda, Calif.* (9th Cir. 2013) 730 F3d 1111, 1121, fn. 4—acknowledging "fraud-created-the-market" theory but observing it "has been criticized in many circuits and we have not accepted it in ours"; *Malack v. BDO Seidman, LLP* (3rd Cir. 2010) 617 F3d 743, 749-755—"fraud-created-the-market" theory rejected]

Whether direct reliance can effectively be dispensed with thus depends on the *degree* of fraud; the essential inquiry is whether the securities were *unmarketable at any price*. [See *Joseph v. Wiles* (10th Cir. 2000) 223 F3d 1155, 1163-1165 (abrogated on other grounds by *California Pub. Employees' Retirement System v. ANZ Secur., Inc.* (2017) 582 US 497, 504, 137 S.Ct. 2042, 2048)—sale of securities for approximately 1/3 of purchase price undermined "unmarketability" allegation; *Ross v. Bank South, N.A.* (11th Cir. 1989) 885 F2d 723, 731—Ps

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

failed to meet *Shores* threshold ("in *Shores* the misrepresentations went to the concealment of existing factors vital to the viability of the project"); compare *Eckstein v. Balcor Film Investors* (7th Cir. 1993) 8 F3d 1121, 1130-1131—criticizing *Shores,* but allowing Ps opportunity to prove Ds' fraud allowed limited partnership to achieve minimum subscription level necessary to permit issuance of securities]

d) [6:372.7d] **Loss causation distinguished:** The "fraud-on-the-market" theory presumes defendant's misstatements or omissions caused plaintiff to engage in the securities *transaction* ("transaction causation"). Thus, the "fraud-on-the-market" theory creates a rebuttable presumption of reliance, which is distinct from showing that defendant's fraud caused plaintiff's damages ("loss causation"; *see* ¶ *6:373d ff.*). A plaintiff does not have to show "loss causation" as a prerequisite to invoking the "fraud-on-the-market" theory. [*Erica P. John Fund, Inc. v. Halliburton Co.* (2011) 563 US 804, 810-811, 131 S.Ct. 2179, 2185-2186 (*discussed further at* ¶ *6:373u*)]

A plaintiff, however, must still establish loss causation in a fraud-on-the-market case. [See *In re BofI Holding, Inc. Secur. Litig.* (9th Cir. 2020) 977 F3d 781, 789 (*discussed at*¶ 6:373f ff.)]

e) [6:372.7e] **Relevance of generic statements:** If the alleged misrepresentation is a generic statement (e.g., "we have faith in our business model"), the statement's generic nature is relevant to whether the misrepresentation had a price impact (i.e., whether it actually affected the stock's market price). [*Goldman Sachs Group, Inc. v. Arkansas Teacher Retirement System* (2021) 594 US 113, 122-123, 141 S.Ct. 1951, 1960-1961—statement's generic nature is particularly relevant in cases based on "inflation-maintenance" theory (¶ 6:373m)]

[6:372.7f - 6:372.7g] ***Reserved.***

3) [6:372.7h] **"Reliance on regulatory process":** Where securities have been registered with the SEC (or a state regulatory agency), an investor may be justified in relying upon "the integrity of the regulatory process and the truth of any representations made to the appropriate agencies and to the investors at the time of the original issuance." In such circumstances, purchasers of an original issuance need *not* prove actual reliance on the false and misleading statements themselves. [*Arthur Young & Co. v. United States Dist. Ct.* (9th Cir. 1977) 549 F2d 686, 695]

• [6:372.7i] ***Caveat:*** This doctrine has not been widely followed and, indeed, has been criticized as creating "a form of investor's insurance, expanding the SEC's role beyond its intended or realistic scope." [See *Joseph v. Wiles* (10th Cir. 2000) 223 F3d 1155, 1165 (abrogated on other grounds by *California Pub. Employees' Retirement System v. ANZ Secur., Inc.* (2017) 582 US 497, 504, 137 S.Ct. 2042, 2048)]

4) [6:372.7j] **Presumption may be rebutted:** Defendant may rebut a presumption of reliance by showing that plaintiff actually did *not* rely on defendant's misstatements or omissions in making the investment decision. [See *duPont v. Brady* (2nd Cir. 1987) 828 F2d 75, 78; *Atari Corp. v. Ernst & Whinney* (9th Cir. 1992) 981 F2d 1025, 1030—reliance defeated by plaintiff's knowledge financial statements were seriously inaccurate]

Similarly, in a "fraud on the market" case (¶ 6:372.7), defendant may rebut this presumption by showing that the *market* received sufficient credible information from other sources—e.g., news articles—to render defendant's prior misstatements or omissions no longer misleading (i.e., that the market price was not affected by fraud). This has sometimes been referred to as the "truth on the market" defense.

• [6:372.7k] Thus, corporate insiders were excused from liability for inaccurate public sales and product quality reports regarding a new computer where news articles accurately revealed the development risks. [*In re Apple Computer Secur. Litig.* (9th Cir. 1989) 886 F2d 1109, 1116]

• [6:372.7***l***] Similarly, a computer company's failure to disclose the anticipated emergence of competing products that would render its product obsolete was not actionable, because the market already knew of that risk. [*In re Stac Electronics Secur. Litig.* (9th Cir. 1996) 89 F3d 1399, 1409-1410; see also *In re Convergent Technologies Secur. Litig.* (9th Cir. 1991) 948 F2d 507, 513—computer company's statements implying growth in sales of existing products not actionable since market knew company's new products would adversely impact sales by hastening existing products' obsolescence]

• [6:372.7m] The parent corporation of a partly owned subsidiary that was merged back into the parent was not liable for failing to fully disclose its tax motives for creating and merging the subsidiary: The market had received sufficient information from financial analysts and news sources describing the corporation's tax strategy and its ramifications. [*Heliotrope Gen., Inc. v. Ford Motor Co.* (9th Cir. 1999) 189 F3d 971, 975-978]

• [6:372.7n] *Compare:* Of course, whether numerous market articles and reports can negate management's alleged misrepresentations frequently presents a *triable issue of fact*. [See *Provenz v. Miller* (9th Cir. 1996) 102 F3d 1478, 1493; *Kaplan v. Rose* (9th Cir. 1994) 49 F3d 1363, 1376-1377 (overruled on other grounds by *City of Dearborn Heights Act 345 Police & Retirement System v. Align Tech., Inc.* (9th Cir. 2017) 856 F3d 605, 616)]

• [6:372.7***o***] *Distinguish:* Where plaintiff alleged actual reliance on specific representations by corporate insiders (*¶ 6:372.5*), the *market's* knowledge of the true facts was *irrelevant*. [See *In re Apple Computer Secur. Litig.* (9th Cir. 1989) 886 F2d 1109, 1114]

a) [6:372.7p] **Defendants bear burden of persuasion:** If a plaintiff satisfies the prerequisites for the "fraud on the market" presumption (¶ 6:372.7), the defendant must prove by a preponderance of the evidence that the alleged misrepresentation did not have a price impact. Merely producing some evidence of a lack of price impact is not enough. [*Goldman Sachs Group, Inc. v. Arkansas Teacher Retirement System* (2021) 594 US 113, 125-126, 141 S.Ct. 1951, 1962-1963]

[6:372.7q - 6:372.7s] ***Reserved.***

5) [6:372.7t] **Compare—reliance thwarted by "nonreliance clause" in stock purchase contract:** Parties to a contract for the sale of securities can include a provision stating that the purchasers have not relied on any representations except those expressly set forth in the contract (i.e., a "nonreliance clause"). This precludes a claim of reliance upon any deceptive statements made prior to the contract and hence prevents securities fraud suits based on the prior statements. [*Rissman v. Rissman* (7th Cir. 2000) 213 F3d 381, 383-385]

6) [6:372.7u] **Compare—reliance not required in SEC injunctive action:** In seeking to *enjoin* SEC Rule 10b-5 violations (*¶ 6:374.4*), the SEC need not allege or prove any investor actually relied upon the misrepresentation or omission. [*SEC v. Rana Research, Inc.* (9th Cir. 1993) 8 F3d 1358, 1363-1364]

(i) [6:372.8] **"In connection with" requirement:** A SEC Rule 10b-5 plaintiff must also prove defendant's fraud was "in connection with" the purchase or sale of a security. This has been broadly construed to include any fraudulent conduct reasonably calculated to affect the investment decision of a reasonable investor. [*SEC v. Texas Gulf Sulphur Co.* (2nd Cir. 1968) 401 F2d 833, 858-862; *Stoyas v. Toshiba Corp.* (9th Cir. 2018) 896 F3d 933, 951; *In re Financial Corp. of America Shareholder Litig.* (9th Cir. 1986) 796 F2d 1126, 1129-1130; see *SEC v. Zandford* (2002) 535 US 813, 819-820, 122 S.Ct. 1899, 1903-1904]

1) Application

• [6:372.8a] A material nondisclosure regarding the *financing* of a securities transaction satisfies the "in connection with" requirement. [*Jett v. Sunderman* (9th Cir. 1988) 840 F2d 1487, 1492-1493 (abrogated on other grounds by *Moore v. Kayport Package Express, Inc.* (9th Cir. 1989) 885 F2d 531, 535-536)—failure to disclose investor was waiving certain defenses on his notes under partnership surety bond]

• [6:372.8b] A broker's sale of his client's securities held in a discretionary trading account and misappropriation of the sale proceeds satisfied the "in connection with" requirement … because the scheme to defraud *coincided with* the securities sales. [*SEC v. Zandford* (2002) 535 US 813, 819-820, 122 S.Ct. 1899, 1903-1904]

• [6:372.8c] On the other hand, an employer's false assurance that if an employee went on short-term disability his stock option rights would be preserved was not sufficiently "in connection with" the purchase or sale of securities. [*Gurwara v. LyphoMed, Inc.* (7th Cir. 1991) 937 F2d 380, 382]

• [6:372.8d] Similarly, defendant's alleged fraud in causing an arbitration panel to undervalue stock that plaintiff had previously contracted to sell defendant did not give rise to a federal securities suit. The mere involvement of a security could not disguise the true nature of the action—i.e., an attempt to reopen an arbitration award after the applicable limitations period had expired. [See *Sander v. Weyerhaeuser Co.* (9th Cir. 1992) 966 F2d 501, 503]

[6:372.8e - 6:372.8f] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2) [6:372.8g] **Product advertisements:** Though a company's product advertisements are not ordinarily made "in connection with" securities sales, the product claims and descriptions contained in the advertisements may influence the market for the company's stock.

Thus, detailed advertisements touting a new drug in technical medical journals may be "in connection with" stock transactions if the advertisements were used by market professionals in evaluating the drug company's stock. [*In re Carter-Wallace, Inc. Secur. Litig.* (2nd Cir. 1998) 150 F3d 153, 156-157; *see*¶ *6:372.7*]

3) [6:372.9] **Fraud must be causally related to purchase or sale:** A fraud not affecting the decision to make the purchase or sale is *not* actionable. [See *Stoyas v. Toshiba Corp.* (9th Cir. 2018) 896 F3d 933, 951; *Latigo Ventures v. Laventhol & Horwath* (7th Cir. 1989) 876 F2d 1322, 1325]

In other words, if the purchase or sale would have occurred in any event, the alleged fraud is factually and legally irrelevant (i.e., no causation). [See *Virginia Bankshares, Inc. v. Sandberg* (1991) 501 US 1083, 1106-1108, 111 S.Ct. 2749, 2765-2766; *Scattergood v. Perelman* (3rd Cir. 1991) 945 F2d 618, 626—majority shareholder with absolute power to effect merger not liable for misstatements directed to minority shareholder regarding merger]

• [6:372.9a] An alleged fraud that occurred *after* the actual purchase cannot satisfy the "in connection with" requirement. [*Roberts v. Peat, Marwick, Mitchell & Co.* (9th Cir. 1988) 857 F2d 646, 652—fraudulent conduct occurring after subscription documents and purchase notes executed (the "purchase and sale"), but before investor payments on notes, not actionable under 10b-5; *Hanon v. Dataproducts Corp.* (9th Cir. 1992) 976 F2d 497, 501]

• [6:372.9b] Similarly, a shareholder cannot bring a SEC Rule 10b-5 action for fraud that occurred *before* they became a shareholder when the fraud had no impact upon the decision to acquire the shares. [See *Davidson v. Belcor, Inc.* (7th Cir. 1991) 933 F2d 603, 606—wife entitled to portion of ex-husband's stock as part of marital property settlement lacked standing to challenge "fraudulent" merger occurring after settlement entered into but before wife received stock]

• [6:372.9c] On the other hand, a shareholder induced to sell stock on the fraudulent promise of a consulting position meets the "in connection with" requirement. The alleged fraud need not be limited to the nature and value of the securities themselves. [See *Leisure Founders, Inc. v. CUC Int'l, Inc.* (SD FL 1993) 833 F.Supp. 1562, 1571]

4) [6:372.10] **Defendant need not purchase or sell securities:** It is not necessary that *defendant* purchased or sold securities. SEC Rule 10b-5 liability will be found so long as the defendant's wrongful conduct *touches and concerns* the purchase and sale of securities by others—i.e., so long as *plaintiff* bought or sold securities in connection with the fraud. [*SEC v. Texas Gulf Sulphur Co.* (2nd Cir. 1968) 401 F2d 833, 858-862; see *Semerenko v. Cendant Corp.* (3rd Cir. 2000) 223 F3d 165, 176-177; *McGann v. Ernst & Young* (9th Cir. 1996) 102 F3d 390, 393-397; *and*¶ *6:284.5*]

(j) [6:373] **Private remedies:** Although SEC Rule 10b-5 provides no express civil remedies, a private right of action is *implied* (¶ *6:360*).

1) [6:373a] **Insider trading liability limited to "contemporaneous" traders:** Where the corporation's stock is publicly-traded on an exchange, plaintiffs asserting insider trading claims must prove their securities transactions were "contemporaneous" with the trading by the insider (or insider's tippee). [*Neubronner v. Milken* (9th Cir. 1993) 6 F3d 666, 669-670; *Brody v. Transitional Hospitals Corp.* (9th Cir. 2002) 280 F3d 997, 1001-1002]

[6:373b - 6:373c] ***Reserved.***

2) [6:373d] **Loss causation requirement:** It is not enough simply to show defendant's fraud caused plaintiff to buy or sell securities (i.e., "transaction causation," ¶ *6:372.5*). A private plaintiff must also prove a causal connection between the *fraud* and plaintiff's *loss*. [SEA § 21D(b)(4) (15 USC § 78u-4(b)(4)); see *Dura Pharmaceuticals, Inc. v. Broudo* (2005) 544 US 336, 342, 125 S.Ct. 1627, 1631; *Curry v. Yelp Inc.* (9th Cir. 2017) 875 F3d 1219, 1224-1225; *Lloyd v. CVB Fin'l Corp.* (9th Cir. 2016) 811 F3d 1200, 1209-1211; *Loos v. Immersion Corp.* (9th Cir. 2014) 762 F3d 880, 883, 887-890—corporation's announcement of internal investigation into revenue accounting practices does not itself establish loss causation between decline in stock price and allegedly fraudulent misstatement of revenues]

a) [6:373e] **Loss causation as proximate cause:** Loss causation is simply a variant of proximate cause. As such, loss causation is context-dependent, because "there are an infinite variety of ways for a tort to cause a loss." To show a causal connection between the fraud and the loss, plaintiff need only trace the loss to the *facts* about which defendant lied. Plaintiff need not necessarily show a causal connection between defendant's *fraudulent conduct* and

the loss. E.g., loss causation may be proved by showing that the price of the securities fell upon revelation of an earnings miss even if the market was unaware at the time that fraud had concealed the miss. [*Mineworkers' Pension Scheme v. First Solar Inc.* (9th Cir. 2018) 881 F3d 750, 753-754 (per curiam); *Lloyd v. CVB Fin'lCorp.* (9th Cir. 2016) 811 F3d 1200, 1209-1211 (internal quotes omitted)]

b) [6:373f] **Corrective disclosures; loss causation in "fraud-on-the-market" cases:** A plaintiff can satisfy the "loss causation" pleading requirement by alleging that (i) a "corrective disclosure" revealed the truth about the defendant's misrepresentation, and (ii) the revelation of the corrective disclosure caused the company's stock price to drop and its investors to lose money. [*Grigsby v. BofI Holding, Inc.* (9th Cir. 2020) 979 F3d 1198, 1205; see also *Loos v. Immersion Corp.* (9th Cir. 2014) 762 F3d 880, 887 (to plead corrective disclosure, "the plaintiff must plausibly allege that the defendant's fraud was *revealed* to the market and *caused* the resulting losses") (internal quotes omitted) (emphasis in original)]

1/ [6:373g] **"Corrective disclosure" defined:** A corrective disclosure "occurs when 'information correcting the misstatement or omission that is the basis for the action is disseminated to the market.'" [*In re BofI Holding, Inc. Secur. Litig.* (9th Cir. 2020) 977 F3d 781, 790 (quoting SEA § 21D(e)(1) (15 USC § 78u-4(e)(1)))]

2/ [6:373h] **Corrective disclosures can come from any source:** Corrective disclosures can come from any source, including knowledgeable third parties (e.g., whistleblowers, analysts, or investigative reporters). Corrective disclosures are *not* limited to admissions of fraud by the defendant or formal findings by government agencies. [*In re BofI Holding, Inc. Secur. Litig.* (9th Cir. 2020) 977 F3d 781, 790]

3/ [6:373i] **Partial corrective disclosures:** A plaintiff may rely on a series of partial disclosures that are disseminated over time that, collectively, reveal the true facts concealed by the defendant's misstatements. A disclosure does not have to reveal the full scope of a defendant's fraud "in one fell swoop" to be "corrective." [*In re BofI Holding, Inc. Secur. Litig.* (9th Cir. 2020) 977 F3d 781, 790]

4/ [6:373j] **Corrective disclosures need not be precise:** A disclosure does not have to "precisely mirror" the defendant's misrepresentation to be "corrective." The disclosure must only "render some aspect of the defendant's prior statements false or misleading." [*In re BofI Holding, Inc. Secur. Litig.* (9th Cir. 2020) 977 F3d 781, 790 (internal quotes omitted)]

5/ [6:373k] **Publicly available sources; Freedom of Information Act (FOIA) requests:** In general, information that is derived entirely from publicly available sources cannot be a "corrective disclosure," because it is presumed that publicly available information is already reflected in the price of a security. [*Grigsby v. BofI Holding, Inc.* (9th Cir. 2020) 979 F3d 1198, 1205, 1208-1209—anonymous article on crowd-sourced investing website did not qualify as corrective disclosure because information derived from publicly available documents]

A plaintiff, however, *may* still rely on a corrective disclosure that is based on publicly available information if the plaintiff explains "why the information was not yet reflected in the company's stock price." For pleadings purposes, a plaintiff must "allege particular facts plausibly suggesting that other market participants *had not* done the same analysis, rather than 'could not.'" [*In re BofI Holding, Inc. Secur. Litig.* (9th Cir. 2020) 977 F3d 781, 794-795 (refusing to categorically disqualify blog posts on crowd-sourced investing website as potential corrective disclosures) (emphasis in original)]

Information that is discoverable through a FOIA request is not considered publicly available for purposes of loss causation until the relevant information was requested and produced. [*Grigsby v. BofI Holding, Inc.*, supra, 979 F3d at 1205-1206—newspaper article containing information obtained through FOIA request could qualify as corrective disclosure for purposes of establishing loss causation]

6/ [6:373*l*] **Application in "fraud-on-the-market" cases; proving "inflated" purchase prices:** In fraud-on-the-market cases, a plaintiff's theory of loss causation generally "begins with the allegation that the defendant's misstatements (or other fraudulent conduct) artificially inflated the price at which the plaintiff purchased her shares—meaning the price was higher than it would have been had the false statements not been made." To establish loss causation in a fraud-on-the-market case, a plaintiff must show that (1) "the truth became known," and (2) "the revelation caused the fraud-induced inflation in the stock's price to be reduced or eliminated." [*In re BofI Holding Inc. Secur. Litig.* (9th Cir. 2020) 977 F3d 781, 789; see also *Dura Pharmaceuticals, Inc. v. Broudo* (2005) 544 US 336, 342-343, 125 S.Ct. 1627, 1631-1632]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Corrective disclosures (¶ 6:373f ff.) are the "most common way for plaintiffs to prove that 'the truth became known.'" [*In re BofI Holding Inc. Secur. Litig.*, supra, 977 F3d at 790]

Caution: To satisfy loss causation, a subsequent price decline must be *attributable to the fraud*. Plaintiff's sale of the stock at a lower price may reflect market or economic factors *other than* (or in addition to) the fraud. Indeed, "the longer the time between purchase and sale, the more likely that this is so, *i.e.,* the more likely that other factors caused the loss." [*Dura Pharmaceuticals, Inc. v. Broudo* (2005) 544 US 336, 343, 125 S.Ct. 1627, 1632 (emphasis in original); see *In re Oracle Corp. Secur. Litig.* (9th Cir. 2010) 627 F3d 376, 392-394; *Nuveen Municipal High Income Opportunity Fund v. City of Alameda, Calif.* (9th Cir. 2013) 730 F3d 1111, 1123 (principle applied to debt instruments)]

7/ [6:373m] **"Inflation-maintenance" likewise actionable:** Several circuits have adopted the theory of "inflation maintenance": Defendant may be liable for a misstatement that *maintains* a security's artificially high price even if the misstatement does *not cause an increase* in the security's price. "There is no reason to draw any legal distinction between fraudulent statements that wrongfully *prolong* the presence of inflation in a stock price and fraudulent statements that initially *introduce* that inflation." To hold otherwise would permit a corporation, once a market is already misinformed about a particular truth, "to knowingly and intentionally reinforce material misconceptions by repeating falsehoods with impunity." [*In re Vivendi, S.A. Secur. Litig.* (2nd Cir. 2016) 838 F3d 223, 259 (emphasis in original); *Glickenhaus & Co. v. Household Int'l, Inc.* (7th Cir. 2015) 787 F3d 408, 418; *FindWhat Investor Group v. FindWhat.com* (11th Cir. 2011) 658 F3d 1282, 1316]

Caution: Although the inflation-maintenance theory is recognized by several circuit courts of appeal (¶ 6:373m), the Supreme Court "has expressed no view on its validity or its contours." [*Goldman Sachs Group, Inc. v. Arkansas Teacher Retirement System* (2021) 594 US 113, 120, 141 S.Ct. 1951, 1959, fn. 1]

c) [6:373n] **Proof of damages distinguished:** To establish causation between the fraud and plaintiff's injury, plaintiff need only prove that the fraud was a *substantial* cause of the loss; the fraud need *not* have been the *sole* cause of the loss. [*In re Daou Systems, Inc., Secur. Litig.* (9th Cir. 2005) 411 F3d 1006, 1025; *Miller v. Asensio & Co., Inc.* (4th Cir. 2004) 364 F3d 223, 232 (abrogation on other grounds recognized by *Glazer Capital Mgmt., L.P. v. Forescout Techs., Inc.* (9th Cir. 2023) 63 F4th 747, 766)]

However, plaintiff can recover only the *amount* of the loss *caused solely by defendant's fraud*. Thus, where the fraud was *one* substantial factor in, e.g., causing the decline in the market price of a public company's stock, but other factors contributed to the decline, plaintiff may be unable to prove the *amount of damages attributable solely to defendant's* acts. Plaintiff would thus be left in the anomalous position of achieving a victory on the liability issue but a defeat on proving actual damages. [*Miller v. Asensio & Co., Inc.*, supra, 364 F3d at 232-233]

d) [6:373***o***] **Rescissionary damages available:** A plaintiff who proves defendant's fraud induced plaintiff to purchase (or sell) securities may elect to rescind the transaction. However, rescission remains an equitable remedy that may be applied in appropriate circumstances *in the court's discretion.* And, in any event, plaintiff seeking to rescind a securities transaction must still prove *economic loss* and *loss causation*. [*Strategic Diversity, Inc. v. Alchemix Corp.* (9th Cir. 2012) 666 F3d 1197, 1207-1209]

Even where true rescission is unavailable because plaintiff or defendant cannot return all the consideration or be restored to the status quo ante, plaintiff may be entitled to a rescissionary measure of *monetary damages*. [*Strategic Diversity, Inc. v. Alchemix Corp.*, supra, 666 F3d at 1206-1209]

e) [6:373p] **Heightened pleading requirements apply:** Loss causation must be pleaded "with particularity" (per FRCP 9(b)). (A "short and plain statement" (per FRCP 8(a)(2)) does not suffice.) [*Oregon Pub. Employees Retirement Fund v. Apollo Group Inc.* (9th Cir. 2014) 774 F3d 598, 605; see SEA § 21D(b)(4) (15 USC § 78u-4(b)(4))]

[6:373q - 6:373t] ***Reserved.***

f) [6:373u] **Proof of loss causation not required to obtain class certification:** In a class action based on the "fraud-on-the-market" theory (¶ 6:372.7 ff.), proof of loss causation is not a prerequisite to obtaining class certification. [*Erica P. John Fund, Inc. v. Halliburton Co.* (2011) 563 US 804, 809-813, 131 S.Ct. 2179, 2184-2186]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Nevertheless, defendant can submit proof at the class certification stage that the fraud did not in fact affect the stock price, and thereby defeat the loss causation presumption. [*Halliburton Co. v. Erica P. John Fund, Inc.* (2014) 573 US 258, 279-281, 134 S.Ct. 2398, 2414-2415]

3) [6:373.1] **Statutory damages cap:** Section 21D(e) provides that where plaintiff seeks to establish damages "by reference to the *market price* of a security," plaintiff's recovery may not exceed the difference between the purchase or sale price and the "mean trading price" during the 90-day period beginning on the date on which information *correcting the misstatement or omission* is disseminated to the market. [SEA § 21D(e)(1) (15 USC § 78u-4(e)(1)) (emphasis added)]

However, where plaintiff sells or repurchases the security *before* expiration of the 90-day period, plaintiff's recovery may not exceed the difference between the purchase or sale price and the "mean trading price" during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which plaintiff sells or repurchases the security. [SEA § 21D(e)(2) (15 USC § 78u-4(e)(2))]

The "mean trading price" is the *average* of the *daily trading price* as of the close of the market each day during the 90-day period. [SEA § 21D(e)(3) (15 USC § 78u-4(e)(3))]

a) [6:373.2] **Equitable limits on recovery:** Collective damages by class action plaintiffs in insider trading cases can be enormous, greatly exceeding the amount of securities the defendant bought or sold. Thus, courts tend to limit plaintiffs' recovery in such cases to disgorgement of defendant's profits from the insider trading (see, e.g., *Elkind v. Ligget & Meyers, Inc.* (2nd Cir. 1980) 635 F2d 156, 173). The Insider Trading and Securities Fraud Enforcement Act similarly limits recovery to the profit gained or loss avoided by the violator. [SEA §§ 20A(b)(1), 21A(a) (15 USC §§ 78t-1(b)(1), 78u-1(a))]

1/ [6:373.2a] **No disgorgement of profits due to special efforts:** However, plaintiff may not recover *all* the insider trader's profits where they resulted from defendant's *special skills and efforts* after the fraudulent transaction—e.g., where a defrauding purchaser helps a company's stock increase in value by extending personal guaranties on bank loans for working capital. [See *Janigan v. Taylor* (1st Cir. 1965) 344 F2d 781, 786; *Pidcock v. Sunnyland America, Inc.* (11th Cir. 1988) 854 F2d 443, 447-448]

b) [6:373.2b] **Other measures of compensatory damages?** Section 21D(e) (*¶ 6:373.1*) is obviously intended to apply to insider trading in securities having a ready public market. It is not clear whether SEA § 21D(e) would apply to securities lacking a public market.

Even before enactment of § 21D(e), the "out-of-pocket" measure was regarded as the ordinary damages standard in a SEC Rule 10b-5 action (based on the "actual damages" standard of SEA § 18(a)). Nevertheless, courts exercised wide discretion in allowing alternative measures of recovery, including "benefit-of-the-bargain" damages or rescission. [See *Blackie v. Barrack* (9th Cir. 1975) 524 F2d 891, 909; *McMahan & Co. v. Wherehouse Entertainment, Inc.* (2nd Cir. 1995) 65 F3d 1044, 1049; *Bruschi v. Brown* (11th Cir. 1989) 876 F2d 1526, 1531; see also SEA §§ 18(a), 21D(e) (15 USC §§ 78r(a), 78u-4(e))]

Section 21D(e) renders the continued viability of these cases questionable.

1/ [6:373.2c] **Compare—SA § 11 actions:** Out-of-pocket loss is the sole measure of damages in SA § 11 actions. [See *McMahan & Co. v. Wherehouse Entertainment, Inc.* (2nd Cir. 1995) 65 F3d 1044, 1047-1048, *discussed at¶ 5:62a*; see also SA § 11 (15 USC § 77k)]

c) [6:373.3] **Offset for tax benefits?** It is unsettled whether a SEC Rule 10b-5 defendant can offset plaintiff's tax benefits from the investment against claimed damages. Where rescission is sought, or the recovery is based on a rescissionary measure of damages, tax benefits are *not* deducted. [See *Randall v. Loftsgaarden* (1986) 478 US 647, 656-660, 106 S.Ct. 3143, 3149-3151; *Rousseff v. E.F. Hutton Co., Inc.* (11th Cir. 1988) 843 F2d 1326, 1330; also see *DCD Programs, Ltd. v. Leighton* (9th Cir. 1996) 90 F3d 1442, 1446-1451—damages may not include expected tax benefits subsequently disallowed by IRS]

But where the action is for *out-of-pocket damages*, such a reduction may be proper (*see¶ 5:71.3*).

d) [6:373.3a] **Injunctive relief to protect potential damages remedy?** The circuits are divided on whether federal courts may grant injunctions to protect *potential future damages remedies* in SEC Rule 10b-5 actions:

• The First and Third Circuits permit the issuance of preliminary injunctions freezing a defendant's assets before trial where the value of the encumbered assets bears a *reasonable relationship* to the value of plaintiff's expected

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

recovery (and the traditional requirements for obtaining equitable relief are met). [*Hoxworth v. Blinder, Robinson & Co., Inc.* (3rd Cir. 1990) 903 F2d 186, 194-197; see also *Teradyne, Inc. v. Mostek Corp.* (1st Cir. 1986) 797 F2d 43, 51-54 (breach of contract action)]

• But the Eleventh Circuit holds that where plaintiff seeks only monetary damages, federal courts lack injunctive power; plaintiff's only recourse is to seek prejudgment *attachment* under FRCP 64. [*Rosen v. Cascade Int'l, Inc.* (11th Cir. 1994) 21 F3d 1520, 1526, 1530; see *In re Fredeman Litig.* (5th Cir. 1988) 843 F2d 821, 824-826—injunction inappropriate to protect future damages remedy under RICO]

4) [6:373.3b] **Attorney fees and costs; FRCP 11 sanctions:** Neither SEA § 10(b) nor SEC Rule 10b-5 authorizes an attorney fees recovery.

Nevertheless, upon final adjudication of any private action under the 1934 Act, the court must make specific findings regarding compliance by the parties *and their counsel* with each requirement of FRCP 11(b) as to any *complaint, responsive pleading* or *dispositive motion*. (Under FRCP 11(b), a paper submitted to the court by any attorney (or unrepresented party) is deemed to contain a certification that the claims, defenses, and/or other legal contentions are legally and factually supportable.) [SEA § 21D(c)(1) (15 USC § 78u-4(c)(1))]

If the court determines that a party or attorney violated FRCP 11(b), it *must* (upon notice and opportunity to respond) award *sanctions*, unless the party or attorney to be sanctioned proves the sanctions would be *unjust* and an *unreasonable burden*. [SEA § 21D(c)(2), (3) (15 USC § 78u-4(c)(2), (3)); see *City of Livonia Employees' Retirement System v. Boeing Co.* (7th Cir. 2013) 711 F3d 754, 761-762]

a) [6:373.3c] **Attorney fees and costs as presumptively proper sanction:** For failure of any *responsive pleading or dispositive motion* to comply with FRCP 11(b), an award of attorney fees and expenses incurred *as a direct result of the violation* is presumed an appropriate sanction. [SEA § 21D(c)(3)(A)(i) (15 USC § 78u-4(c)(3)(A)(i))]

For "substantial failure" of any *complaint* to comply with FRCP 11(b), an award of attorney fees and expenses incurred *in the action* is presumptively a proper sanction. [SEA § 21D(c)(3)(A)(ii) (15 USC § 78u-4(c)(3)(A)(ii))]

Cross-refer: For a comprehensive treatment of FRCP 11 sanctions, see Stevenson & Fitzgerald, *Rutter Group Prac. Guide: Federal Civ. Pro. Before Trial* (TRG), Ch. 17.

5) [6:373.4] **No punitive damages:** In any event, punitive damages are *not* available in a private SEC Rule 10b-5 action. [*Green v. Wolf* (2nd Cir. 1968) 406 F2d 291, 302-303]

➪ [6:374] ***PRACTICE POINTER:*** It may be possible to obtain punitive damages by *joining* a common law (state) claim for *fraud*, and alleging "malicious" intent to injure or deceive, where applicable. (The common law fraud claim ordinarily can be adjudicated under federal supplemental jurisdiction.)

6) [6:374a] **Apportionment of liability:** All defendants who *knowingly* violate SEC Rule 10b-5 are jointly and severally liable for plaintiff's damages. [SEA § 21D(f)(2)(A) (15 USC § 78u-4(f)(2)(A)); see SEA § 21D(f)(10) (15 USC § 78u-4(f)(10))—recklessness is not "knowing" conduct]

On the other hand, defendants who did *not* knowingly violate Rule 10b-5 are responsible only to the extent they caused or contributed to plaintiff's loss; their *percentage of responsibility* is determined by the trier of fact. [SEA § 21D(f)(2), (3) (15 USC § 78u-4(f)(2), (3))]

a) [6:374b] **Additional responsibility if judgment uncollectible:** In addition to their proportionate share of responsibility for an unintentional ("unknowing") violation, a defendant may be jointly and severally liable, *up to 50% of their share* of liability, for any portion of a judgment against a codefendant that proves *uncollectible*. [SEA § 21D(f)(4)(A)(ii) (15 USC § 78u-4(f)(4)(A)(ii))]

The 50% limitation does *not* apply if:

• Plaintiff's damages exceed 10% of their net worth; and

• Plaintiff's net worth is $200,000 or less. [SEA § 21D(f)(4)(A)(i) (15 USC § 78u-4(f)(4)(A)(i))]

b) [6:374c] **Contribution among defendants:** A defendant who is jointly and severally liable with others "may recover contribution from any other person who, if joined in the original action, would have been liable for the same damages." The amount of the contribution is determined based on *percentage of responsibility* (*see*¶ *6:374a*). [SEA § 21D(f)(8) (15 USC § 78u-4(f)(8))]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

A defendant who committed an unintentional ("unknowing") violation and who is forced to pay all or any portion of an *uncollectible judgment* (¶ *6:374b*) has a right to contribution from:

- the person originally liable on the judgment;
- any defendant who is held jointly and severally liable;
- any other defendant who is likewise compelled to pay for an uncollectible judgment and who has not paid their proportionate share; and
- any other person responsible for the conduct giving rise to the payment. [SEA § 21D(f)(5) (15 USC § 78u-4(f)(5))]

c) [6:374d] **Settling defendant's discharge from contribution:** A defendant who settles any time *before final verdict or judgment* is discharged from all claims for contribution; and they are likewise barred from pursuing contribution against any person (other than a person whose liability has been extinguished by the settlement—e.g., a person liable as a "control" person). [SEA § 21D(f)(7)(A) (15 USC § 78u-4(f)(7)(A)); see *In re Heritage Bond Litig.* (9th Cir. 2008) 546 F3d 667, 676-680—contribution bar does not apply to nonsettling defendant's claim against settling defendant seeking damages independent of nonsettling defendant's liability to plaintiff]

In return for the discharge, the verdict or judgment against the remaining (nonsettling) defendants is reduced by the *greater* of (i) the settlor defendant's percentage of responsibility (¶ *6:374a*), or (ii) the settlement amount. [SEA § 21D(f)(7)(B) (15 USC § 78u-4(f)(7)(B))]

[6:374e - 6:374g] ***Reserved.***

d) [6:374h] **Indemnification:***See*¶ *5:71.5*.

e) [6:374i] **Statute of limitations:***See* ¶ *6:375.2g*.

7) [6:374j] **Arbitration:** Predispute arbitration agreements providing for the arbitration of claims under the 1934 Act are valid and enforceable. [*Shearson/American Express, Inc. v. McMahon* (1987) 482 US 220, 238, 107 S.Ct. 2332, 2343; *see*¶ *5:75.13 ff.*]

(k) [6:374.1] **SEC action for treble damages:** The SEC can seek a civil penalty of up to three times the amount of profit gained (or loss avoided) by persons who trade on inside information in violation of SEC Rule 10b-5 (or any other provision of the 1934 Act). [SEA § 21A(a)(2) (15 USC § 78u-1(a)(2))] Nontrading tippors are likewise subject to such liability. [SEA §§ 20A(c), 21A(a)(1), (2) (15 USC §§ 78t-1(c), 78u-1(a)(1), (2))]

1) [6:374.1a] **Controlling persons' liability:** Further, employers or other "controlling" persons may be subject to treble damages liability for violations by their employees or controlled persons if:

- They failed to take "appropriate" preventive action once aware or "in reckless disregard" of the fact that the controlled person was likely to engage in insider trading or tipping (SEA § 21A(b)(1)(A) (15 USC § 78u-1(b)(1)(A)); or
- They are an SEC-registered broker-dealer or investment advisor, and knowingly or recklessly failed to establish, maintain and enforce written policies and procedures "reasonably" designed to prevent misuse of inside information by their employees, associates and other persons associated with them (as may be prescribed by the SEC) (SEA §§ 15(f), 21A(b)(1)(B) (15 USC §§ 78***o***(f), 78u-1(b)(1)(B)).

2) [6:374.1b] **Aiders' and abettors' liability:** Persons who *knowingly or recklessly* provide *substantial assistance* to another person in violation of SEC Rule 10b-5 (or any other provision of the 1934 Act) are liable to the same extent as the person to whom such assistance is provided. [SEA § 20(e) (15 USC § 78t(e))]

a) [6:374.1c] **SEC's burden of proof:** To establish aider and abettor liability, the SEC must prove (i) a securities law *violation* by the *primary party*, (ii) the aider and abettor's *knowledge of this violation*, and (iii) the aider and abettor's *substantial assistance* in committing the primary violation. (The SEC need *not* prove that the aider and abettor "*proximately caused*" the primary violation.) [*SEC v. Apuzzo* (2nd Cir. 2012) 689 F3d 204, 211-213]

3) [6:374.2] **Applies only to exchange trades:** However, to be subject to this penalty, the trades must have been made on or through the facilities of a national securities exchange; or from or through a broker or dealer. The Act

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

does not apply to a public offering of the issuer (other than standardized options or security futures products). [SEA § 21A(a)(1) (15 USC § 78u-1(a)(1))]

4) [6:374.3] **Not available in private actions:** This penalty is not available in private actions under SEC Rule 10b-5. *Only the SEC* can seek civil penalties.

5) [6:374.4] **Compare—civil penalties and injunctions:** As with 1933 Act violations (*¶ 5:74 ff.*), the SEC may institute proceedings to enjoin actual or threatened violations of SEA § 10(b) and SEC Rule 10b-5. Remedies include disgorgement of profits, substantial monetary penalties or an injunction barring the individual from serving as officer or director of a 1934 Act "reporting" company. [SEA § 21(d) (15 USC § 78u(d)); see *SEC v. World Capital Market, Inc.* (9th Cir. 2017) 864 F3d 996, 1003-1004—disgorgement may also be ordered from nonviolating third parties who received proceeds of others' violations to which the third parties have no legitimate claim; *SEC v. First Pac. Bancorp* (9th Cir. 1998) 142 F3d 1186, 1190-1194; *United States v. Gartner* (9th Cir. 1996) 93 F3d 633, 635—disgorgement may be ordered in addition to criminal penalties]

To obtain an injunction, the SEC must prove the elements necessary to establish a 10b-5 violation (i.e., scienter, material misrepresentation or omission in connection with purchase or sale of a security, etc.). However, the SEC need *not* prove *reliance*. [See *SEC v. Rana Research, Inc.* (9th Cir. 1993) 8 F3d 1358, 1363-1364]

a) [6:374.5] **Right to jury trial:** Either the SEC or the defendant may request a jury trial where the SEC seeks *legal* remedies, such as monetary penalties. But there is *no* right to a jury trial where the SEC seeks purely *equitable* remedies, such as an injunction or disgorgement of illicit profits. Where both equitable and legal remedies are sought in the same action, either party may obtain a jury trial on the *legal* claim, *including all issues common to both claims*. [*SEC v. Jensen* (9th Cir. 2016) 835 F3d 1100, 1106 & fn. 2; *SEC v. Rind* (9th Cir. 1993) 991 F2d 1486, 1493]

b) [6:374.6] **Not available in insider trading cases:** SEC remedies under SEA § 21(d) are not available in cases where defendant is subject to a penalty under SEA § 21A for insider trading (*¶ 6:374.1*). [*SEC v. Rosenthal* (2nd Cir. 2011) 650 F3d 156, 158-163—defendant who neither made profits nor avoided losses by trading on inside information was nevertheless "subject to a penalty" under § 21A and hence not susceptible to § 21(d) monetary penalties; see SEA §§ 21(d), 21A (15 USC §§ 78u(d), 78u-1)]

(*l*). [6:375] **Two-year/five-year statute of limitations:** Private suits under SEC Rule 10b-5 must be brought within *two years* after discovery of the facts constituting the violation, but in any event no later than *five years* after the violation occurred. [28 USC § 1658(b)]

• [6:375.1] **Comment:** The two-year/five-year limitations period can eliminate many otherwise viable 10b-5 claims. In particular, investors who purchase securities of nonreporting companies through private placements frequently do not discover they have reason to sue until years later. Plaintiffs who file suit based on general allegations in the hope discovery will unearth supporting evidence risk severe sanctions. [SEA § 21D(c) (15 USC § 78u-4(c)) (*discussed at¶ 6:373.3b*); see SEA § 21D(b) (15 USC § 78u-4(b))—SEC Rule 10b-5 actions must be pleaded with particularity] Consequently, investors in small companies must be vigilant to timely uncover proof of fraud.

[6:375.2 - 6:375.2b] ***Reserved.***

1) Accrual of action

a) [6:375.2c] **Two-year statute accrues upon discovery of fraud:** The two-year statute is triggered when plaintiff *discovers*, or by the exercise of reasonable diligence *would have discovered*, the "*facts constituting the violation*," including facts showing defendant's *scienter*. [28 USC § 1658(b) (emphasis added); *Merck & Co., Inc. v. Reynolds* (2010) 559 US 633, 643-650, 130 S.Ct. 1784, 1793-1797]

Thus, discovery of adverse facts or circumstances *not giving rise to an inference of fraudulent conduct* (e.g., lower-than-expected income, poor sales, decline in stock price) does *not* put plaintiff on notice of fraud. Further, a defendant's *affirmative acts* in *concealing* the fraud may justifiably delay plaintiff's discovery of the fraud and hence postpone running of the statute. [*Merck & Co., Inc. v. Reynolds*, supra; see *York County ex rel. County of York Retirement Fund v. H.P.* (9th Cir. 2023) 65 F4th 459, 467-468—plaintiff lacked sufficient information to plead scienter until SEC issued cease-and-desist order against defendant; *Berry v. Valence Tech., Inc.* (9th

Cir. 1999) 175 F3d 699, 703-705—financial magazine's skeptical article about company's prospects did not put investors on notice of defendants' fraudulent activities]

1/ [6:375.2d] **Caveat re "inquiry notice":** The Supreme Court in *Merck*, supra, criticized cases that stated the two-year limitations period commences when facts are discovered that would lead a reasonably diligent plaintiff to investigate further. "[T]erms such as 'inquiry notice' and 'storm warnings' may be useful to the extent that they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating. But the limitations period does not begin to run until the plaintiff thereafter *discovers or a reasonably diligent plaintiff would have discovered* 'the facts constituting the violation,' including scienter—irrespective of whether the actual plaintiff undertook a reasonably diligent investigation." [*Merck & Co., Inc. v. Reynolds* (2010) 559 US 633, 650-651, 130 S.Ct. 1784, 1797-1798 (emphasis added); see *Strategic Diversity, Inc. v. Alchemix Corp.* (9th Cir. 2012) 666 F3d 1197, 1205-1206]

Stated otherwise, scienter is a "fact"; therefore, plaintiff cannot be on "inquiry notice" until plaintiff, by the exercise of reasonable diligence, would have discovered the facts showing scienter (and the other elements of a SEC Rule 10b-5 action). [*Merck & Co., Inc. v. Reynolds*, supra, 599 US at 648-651, 130 S.Ct. at 1796-1798]

2/ [6:375.2e] **Effect of equitable tolling on class action:** The statute of limitations is equitably tolled during the pendency of a putative class action in order to allow unnamed class members to join the action individually or, if the class fails, to file individual claims. [*American Pipe & Const. Co. v. Utah* (1974) 414 US 538, 552-553, 94 S.Ct. 756, 765-766]

However, where class certification is *denied*, equitable tolling does not allow a putative class member to commence a new class action beyond the 28 USC § 1658(b) two-year limitations period. "*American Pipe* does not permit a plaintiff who waits out the statute of limitations to piggyback on an earlier, timely filed class action." Rather, the putative class member must promptly join an existing suit or file an individual action. [*China Agritech, Inc. v. Resh* (2018) 584 US 732, 740, 138 S.Ct. 1800, 1806]

b) [6:375.2f] **Five-year statute accrues upon *sale of securities:*** All SEC Rule 10b-5 actions are *absolutely time-barred* five years after *sale* of the securities. In contrast to the two-year statute of limitations, the five-year statute is a statute of *repose* that acts as a *complete cut-off*. Hence, it is *not* subject to equitable tolling. [See *China Agritech, Inc. v. Resh* (2018) 584 US 732, 736, 138 S.Ct. 1800, 1804 & fn. 1; *Merck & Co., Inc. v. Reynolds* (2010) 559 US 633, 650, 130 S.Ct. 1784. 1797; *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson* (1991) 501 US 350, 363, 111 S.Ct. 2773, 2782 (predating 28 USC § 1658(b)); *Durning v. Citibank, Int'l* (9th Cir. 1993) 990 F2d 1133, 1136-1137 (same)]

c) [6:375.2g] **Contribution actions:** The two-year/five-year statute of limitations also applies to actions by a SEC Rule 10b-5 defendant seeking *contribution* from another (¶ *6:374c*). However, the contribution action does not accrue until the defendant has *satisfied the judgment* in the underlying action. [*Asdar Group v. Pillsbury, Madison & Sutro* (9th Cir. 1996) 99 F3d 289, 296 (predating 28 USC § 1658(b), ¶ *6:375*)]

[6:375.2h] *Reserved.*

2) [6:375.2i] **Analogous two-year/five-year statute for California actions:** A similar statute of limitations applies to suits for *securities fraud* under *California law* (Corps.C. § 25501 for violations of Corps.C. § 25401, *see*¶ *5:390 ff.*)—two years after discovery of the facts constituting the violation or five years after the transaction, whichever occurs first. [Corps.C. § 25506(b); *see*¶ *5:414 ff.*]

3) [6:375.3] **Compare—five-year limitations period under Insider Trading and Securities Fraud Enforcement Act of 1988:** This law establishes a five-year statute of limitations for private actions against inside traders brought by those who trade contemporaneously in the market (*see*¶ *6:368.1a*). [SEA § 20A (15 USC § 78t-1); see *Johnson v. Aljian* (9th Cir. 2007) 490 F3d 778, 781-783—action barred by SEC Rule 10b-5 2-year/5-year statute may nevertheless be brought under § 20A within 5-year period]

4) [6:375.3a] **Compare—five-year limitations period on SEC civil penalty action:** An action "for the enforcement of any civil fine, penalty, or forfeiture" must be brought within *five years* "from the date when the claim first accrued." [28 USC § 2462; see *Kokesh v. SEC* (2017) 581 US 455, 463-465, 137 S.Ct. 1635, 1643-1644—§ 2462 5-year limitations period applies to SEC disgorgement action; *Gabelli v. SEC* (2013) 568 US 442, 447-451, 133

S.Ct. 1216, 1220-1222—§ 2462 5-year limitations period begins when fraud was *committed* and not later when fraud was *discovered* (action under Investment Company Act of 1940); *SEC v. Berry* (ND CA 2008) 580 F.Supp.2d 911, 918-919; *also see*¶ *5:75.1*]

(m) [6:375.4] **Procedural matters:** Federal courts have *exclusive jurisdiction* in SEC Rule 10b-5 actions. In addition, *nationwide service of process* is authorized, so that defendant need not be subject to personal jurisdiction in the federal district where suit is filed. Venue is proper either in the district where defendant resides or transacts business *or* where the acts constituting the violation occurred. [SEA § 27 (15 USC § 78aa)]

(n) [6:375.5] **Preclusion ("preemption") of state securities fraud actions (SLUSA):** The Securities Litigation Uniform Standards Act (SLUSA) precludes certain state law "covered class actions" (¶ *6:375.7*), whether brought under state common law or statutes, alleging *market manipulation* or material *misstatements or omissions* in connection with the purchase or sale of "covered securities" (¶ 6:375.6). [SEA § 28(f)(1) (15 USC § 78bb(f)(1)); SA § 16(b) (15 USC § 77p(b)); see *Chadbourne & Parke LLP v. Troice* (2014) 571 US 377, 383-387, 134 S.Ct. 1058, 1063-1066 (discussed at ¶ *6:375.8*); *Kircher v. Putnam Funds Trust* (2006) 547 US 633, 635-637, 126 S.Ct. 2145, 2150-2151; compare *Luther v. Countrywide Fin'l Corp.* (2011) 195 CA4th 789, 794-797, 125 CR3d 716, 719-721—no preclusion where class action brought in state court did not involve "covered securities"]

(These preclusion provisions are often referred to as "preemption." Here, however, federal securities law does not displace state law; rather, it simply bars the use of state law class actions to redress securities fraud involving "covered securities." *Kircher v. Putnam Funds Trust*, supra, 547 US at 636-637, 126 S.Ct. at 2151, fn. 1; *Hampton v. Pacific Investment Mgmt. Co. LLC* (9th Cir. 2017) 869 F3d 844, 845; *Wells Fargo Bank, N.A. v. Sup.Ct. (Richtenburg)* (2008) 159 CA4th 381, 384-385, 71 CR3d 506, 510, fn. 2.)

1) [6:375.6] **"Covered securities":** "Covered securities" are:

- Securities listed (or authorized for listing) on the New York Stock Exchange, NYSE American (successor to NYSE Amex), Nasdaq Global Market or Nasdaq Global Select Market, or securities equal or senior to these securities, but excluding debt instruments issued in reliance on SEC Rule 506 (¶ *5:172 ff.*) or such other SEC rules or regulations as may be issued in the future under SA § 4(a)(2) (15 USC § 77d(a)(2)); and

- Securities issued by an investment company that is registered (or that has filed a registration statement) under the Investment Company Act of 1940. [SEA § 28(f)(5)(E) (15 USC § 78bb(f)(5)(E)); SA § 16(f)(3) (15 USC § 77p(f)(3)); see SA § 18(b)(1), (2)(15 USC § 77r(b)(1), (2)); and *Falkowski v. Imation Corp.* (9th Cir. 2002) 309 F3d 1123, 1127-1131, amended (2003) 320 F3d 905—fraud in grant of employee stock options issued by "listed" corporation was "in connection with" sale of "covered security" (state law action precluded)]

2) [6:375.7] **"Covered class actions":** Subject to certain exclusions (¶ 6:375.10), "covered class actions" generally comprise suits brought on behalf of *more than 50* actual or prospective class members, as well as so-called "*mass actions*" in which a group of lawsuits filed in the same court is joined or consolidated into a single action. [SEA § 28(f)(5)(B) (15 USC § 78bb(f)(5)(B)); SA § 16(f)(2) (15 USC § 77p(f)(2))]

3) [6:375.8] **"In connection with":** The phrase "in connection with the purchase or sale," as used with respect to preclusion (¶ *6:375.5*), has the same broad meaning as identical language in SEC Rule 10b-5: It encompasses actions based on misstatements or omissions that "coincide" with a securities transaction. [See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit* (2006) 547 US 71, 85-86, 126 S.Ct. 1503, 1513; see also *Freeman Investments, L.P. v. Pacific Life Ins. Co.* (9th Cir. 2013) 704 F3d 1110, 1116-1118; compare *Chadbourne & Parke LLP v. Troice* (2014) 571 US 377, 386-387, 134 S.Ct. 1058, 1066—false statement that certificates of deposit ("uncovered" securities) would be backed by "covered securities" was not "in connection with" sale of "*covered* securities" (hence, no preclusion of state law action)]

a) [6:375.8a] **No "purchase/sale" requirement:** In certain respects, the "in connection with" requirement with respect to preclusion is even broader than its counterpart in SEC Rule 10b-5. The *Blue Chip Stamps* limitation on Rule 10b-5 actions—that a private damages claim must involve an *actual purchase or sale* (¶ *6:372*)—does *not* apply with respect to preclusion under SEA § 28(f)(1) and SA § 16(b). Thus, a state law "covered class action" that does *not* involve an actual purchase or sale of securities (i.e., action alleging defendant fraudulently induced plaintiffs to continue to *hold* securities) is nonetheless precluded. [*Merrill Lynch, Pierce, Fenner & Smith, Inc. v.*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Dabit (2006) 547 US 71, 84-87, 126 S.Ct. 1503, 1512-1514; see SEA § 28(f)(1) (15 USC § 78bb(f)(1)); SA § 16(b) (15 USC § 77p(b))]

[6:375.8b - 6:375.8d] ***Reserved.***

b) Application

• [6:375.8e] A class action by defrauded lenders who relied on financial misrepresentations in the corporation's *SEC filings* was "in connection with" securities purchases/sales and hence was precluded. [*U.S. Mortg., Inc. v. Saxton* (9th Cir. 2007) 494 F3d 833, 844-845 (abrogation on other grounds recognized by *Hampton v. Pac. Investment Mgmt. Co. LLC* (9th Cir. 2017) 869 F3d 844, 846-847)]

• [6:375.8f] A class action by trust beneficiaries alleging the trustee bank reaped undisclosed commissions (and committed other improprieties) by investing trust assets in certain *mutual funds* was "in connection with" securities transactions and was likewise precluded. [*Wells Fargo Bank, N.A. v. Sup.Ct. (Richtenburg)* (2008) 159 CA4th 381, 386-390, 71 CR3d 506, 511-514]

4) [6:375.9] **Nonsecurities actions sounding in securities fraud likewise precluded:** SLUSA preclusion does not turn on the name or title that plaintiff gives to a claim but, rather, on the gravamen or essence of the claim. So long as a state law "covered class action" is based on conduct specified under SLUSA (*see ¶ 6:375.5*), the action is precluded even though not brought as a securities law suit. SLUSA is interpreted broadly to preclude state law claims actionable under federal securities laws but framed as, e.g., breach of fiduciary duty, breach of contract, breach of the covenant of good faith and fair dealing, etc. [*Northstar Fin'l Advisors, Inc. v. Schwab Investments* (9th Cir. 2018) 904 F3d 821, 829]

5) [6:375.10] **Certain actions *not precluded:*** Important *exclusions* from the federal preclusion provisions (i.e., suits are permitted to proceed) include:

• Shareholder derivative actions. [SEA § 28(f)(5)(C) (15 USC § 78bb(f)(5)(C)); SA § 16(f)(2)(B) (15 USC § 77p(f)(2)(B)); see *Proctor v. Vishay Intertechnology, Inc.* (9th Cir. 2009) 584 F3d 1208, 1221-1222]

• Class actions brought in state court alleging exclusively 1933 Act claims. [SA § 22(a) (15 USC § 77v(a)); *Cyan, Inc. v. Beaver County Employees Retirement Fund* (2018) _ US _, _, 138 S.Ct. 1061, 1066 (also holding defendants may not remove such actions to federal court)]

• Certain class actions involving transactions with existing equity holders (e.g., exchange offers, proxy solicitations, etc.) and based on the law of the issuer's state of incorporation (so-called "Delaware carve-out"). [SEA § 28(f)(3)(A) (15 USC § 78bb(f)(3)(A)); SA § 16(d)(1) (15 USC § 77p(d)(1)); see *Madden v. Cowen & Co.* (9th Cir. 2009) 576 F3d 957, 965-971; also see *Proctor v. Vishay Intertechnology, Inc.*, supra, 584 F3d at 1221-1224; compare *Northstar Fin'l Advisors, Inc. v. Schwab Investments* (9th Cir. 2018) 904 F3d 821, 833-834—"carve-out" not applicable where claims not based upon *transactions* with existing equity holders but instead based on defendants' *post-transaction conduct*; *Rainero v. Archon Corp.* (9th Cir. 2016) 844 F3d 832, 835-838—SA § 16(d)(1) does not create independent basis for federal jurisdiction over state law breach of contract action involving preferred stock]

• Enforcement actions by state securities regulators. [SEA § 28(f)(4) (15 USC § 78bb(f)(4)); SA § 16(e) (15 USC § 77p(e))]

• Class actions brought by States and political subdivisions, and State pension plans, so long as the plaintiffs are named and have authorized participation in the action. [SEA § 28(f)(3)(B) (15 USC § 78bb(f)(3)(B)); SA § 16(d)(2) (15 USC § 77p(d)(2)); see H.R. Rep. 105-640, p. 42]

• Class actions to enforce a contract between an issuer and an indenture trustee brought by a contracting party or successor thereto. [SEA § 28(f)(3)(C) (15 USC § 78bb(f)(3)(C)); SA § 16(d)(3) (15 USC § 77p(d)(3))]

[6:375.11 - 6:375.13] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

6) [6:375.14] **Preclusion as jurisdictional:** A dismissal pursuant to SLUSA (¶ 6:375.5) is jurisdictional, thereby preventing the court from addressing the merits of the claim. For this reason, the dismissal must be *without prejudice*. [*Hampton v. Pacific Investment Mgmt. Co. LLC* (9th Cir. 2017) 869 F3d 844, 847]

(o) [6:375.15] **Res judicata and collateral estoppel:** A federal court judgment in a SEC Rule 10b-5 action does not bar trial of state law claims based on the same facts in a subsequent state court action where the federal court declined to exercise "pendent" ("supplemental") jurisdiction. (Reason: state courts lack jurisdiction to hear Rule 10b-5 actions; *see*¶ *6:375.5*.) However, collateral estoppel may apply to prevent relitigating factual questions *actually adjudicated* in the federal action. [*Koch v. Hankins* (1990) 223 CA3d 1599, 1605, 273 CR 442, 446]

For the same reason, a state court judgment does not have preclusive effect on a federal 10b-5 claim. [*Koch v. Hankins*, supra, 223 CA3d at 1605, 273 CR at 446, fn. 5; compare *Matsushita Elec. Industrial Co., Ltd. v. Epstein* (1996) 516 US 367, 375-387, 116 S.Ct. 873, 878-884—state court approval of class action settlement releasing 1934 Act claims precludes subsequent litigation of claims in federal court]

(2) [6:376] **Section 16:** A second major limitation on insider trading is SEA § 16 (15 USC § 78p).

Again, detailed coverage of this provision is beyond the scope of this Guide, but the following highlights should be noted:

(a) [6:377] **Applies only to registered securities:** Unlike SEC Rule 10b-5, § 16 applies only to equity securities registered (or required to be registered) under SEA § 12. (But if *any* class of the corporation's equity securities is registered, all classes of equity securities are subject to § 16.) [SEA § 16(a)(1), (b) (15 USC § 78p(a)(1), (b)); see SEA § 12 (15 USC § 78*l*)]

"Equity securities" include stock options, warrants, debt securities convertible into stock, security-based swap agreements, and other "derivative" securities. [SEA § 16(b) (15 USC § 78p(b)); SEC Rule 16a-1(c) (17 CFR § 240.16a-1(c))]

1) [6:377.1] **Not applicable to foreign private issuers:** Equity securities registered under the SEA by a foreign private issuer are not subject to SEA § 16. A foreign private issuer is a foreign issuer (e.g., a Bermuda company), *other than* a foreign issuer in which 50% of the issuer's outstanding voting securities are directly or indirectly held of record by U.S. residents, *and:*

• A majority of the executive officers and directors are U.S. citizens or residents; *or*

• More than 50% of the issuer's assets are located in the U.S.; *or*

• The issuer's business is administered principally in the U.S. [SEA Rules 3a12-3(b), 3b-4(c) (17 CFR §§ 240.3a12-3(b), 240.3b-4(c)); see SEA § 16 (15 USC § 78p)]

(b) [6:378] **Reporting requirement:** Section 16 requires directors or officers (as well as shareholders owning more than 10% of the outstanding stock) to file periodic reports disclosing any changes in their holdings. [SEA § 16(a) (15 USC § 78p(a)); *Credit Suisse Secur. (USA) LLC v. Simmonds* (2012) 566 US 221, 224, 132 S.Ct. 1414, 1418]

1) [6:378.1] **Corporation's obligation to disclose noncompliance:** The failure of any of the above persons (¶ 6:378) to comply with the § 16 reporting requirements must be disclosed in the corporation's *Form 10-K* and *proxystatements*. In making any such disclosure, the corporation may rely upon copies of reports it receives from the person, and need not make further investigation. [Reg. S-K, Item 405, 17 CFR § 229.405; Form 10-K, Pt III, Item 10; Schedule 14A (Rule 14a-101, 17 CFR § 240.14a-101), Item 7(b)]

(c) [6:379] **"Short-swing" profits belong to corporation:** For the purpose of preventing unfair use of inside information, any *profit* realized by an officer, director or more-than-10% shareholder on *any pair* of purchases and sales within any six-month period belongs to the *corporation*. The profit may be recovered in a direct action by the corporation or in a derivative action by the owner of any security of the corporation. [SEA § 16(b) (15 USC § 78p(b))]

Section 16(b) imposes *strict* liability, whether or not based on inside information and regardless of motive. [*Credit Suisse Secur. (USA) LLC v. Simmonds* (2012) 566 US 221, 223, 132 S.Ct. 1414, 1417]

1) [6:379.1] **"Officers" subject to § 16(b):** Under SEC rules, officers subject to SEA § 16(b) are those persons performing significant *policymaking functions* who in the course of their duties are likely to obtain *confidential information* about the corporation's affairs. [SEC Rule 16a-1(f) (17 CFR § 240.16a-1(f)); see *C.R.A. Realty Corp. v.*

Crotty (2nd Cir. 1989) 878 F2d 562, 567—corporate vice-president occupying essentially honorary position without access to inside information not subject to § 16(b)]

These persons include:

- The president;
- Any vice-president in charge of a principal business unit, division or function;
- The principal financial officer and principal accounting officer (or the controller when there is no principal accounting officer); and
- Officers of a parent company or subsidiary who perform similar policy-making functions for the issuer. [SEC Rule 16a-1(f) (17 CFR § 240.16a-1(f))]

2) [6:379.1a] **"More than 10% shareholders"—initial purchase not counted:** More-than-10% shareholders are liable under SEA § 16 only if they were more than 10% shareholders at *both the time of purchase and the time of sale* (or the sale and repurchase) within the 6-month period. Thus, the purchase by which an owner first becomes a more than 10% shareholder is *not* considered in determining liability (i.e., one must *already be* a more than 10% shareholder before matching purchases and sales (or sales and repurchases) within the 6-month period). [*Foremost-McKesson, Inc. v. Provident Secur. Co.* (1976) 423 US 232, 234, 96 S.Ct. 508, 511-512; *Rosenberg v. XM Ventures* (3rd Cir. 2001) 274 F3d 137, 142; *Editek, Inc. v. Morgan Capital, L.L.C.* (8th Cir. 1998) 150 F3d 830, 831]

3) [6:379.1b] **Shareholder group owning more than 10%:** A group of shareholders who collectively own more than 10% of the corporation's stock are subject to SEA § 16 if they *agree to act together* for the purpose of *acquiring, holding, voting or disposing* of the corporation's stock. The agreement to act together may be formal or informal. Whether such an agreement exists is a question of *fact*, and may be proved by direct or circumstantial evidence. [See *Dreiling v. America Online Inc.* (9th Cir. 2009) 578 F3d 995, 1002-1003; *Roth v. Jennings* (2nd Cir. 2007) 489 F3d 499, 507-509; *Rosenberg v. XM Ventures* (3rd Cir. 2001) 274 F3d 137, 144-148; compare *Lowinger v. Morgan Stanley & Co. LLC* (2nd Cir 2016) 841 F3d 122, 130-132—"lock-up" agreement whereby IPO underwriters restricted sales by pre-IPO shareholders in order to assure orderly IPO did not render underwriters a SEA § 16(b) shareholder "group"]

4) [6:379.2] **Voluntary exchange of securities constitutes § 16(b) sale:** A "sale" for purposes of SEA § 16(b) is interpreted broadly to encompass any *voluntary exchange* of equity securities for cash or other securities.

Thus, an exchange in response to a tender offer, where the shareholder is not compelled to surrender their shares, is a "sale." However, a *forced* exchange (e.g., pursuant to merger or other reorganization over which the SEA § 16 "insider" has no control) is not a "sale" for § 16 purposes and thus does not trigger a disgorgement of resulting profits. [*Colan v. Mesa Petroleum Co.* (9th Cir. 1991) 951 F2d 1512, 1525; see *Kern County Land Co. v. Occidental Petroleum Corp.* (1973) 411 US 582, 602-603, 93 S.Ct. 1736, 1748-1749]

5) [6:379.2a] **Dividends ordinarily excluded from "profit":** A dividend that is neither contingent upon nor influenced by the occurrence or timing of a "short-swing" purchase and sale is not "profit" that must be disgorged by a SEA § 16(b) insider. This is so whether the dividend is ordinary or extraordinary (e.g., arising from the sale of assets). A dividend is subject to disgorgement if it results from the insider's *manipulation* (e.g., the insider engineers the dividend declaration and then purchases shares before the declaration is publicly announced). [*Steel Partners II, L.P. v. Bell Indus., Inc.* (2nd Cir. 2002) 315 F3d 120, 124-127]

[6:379.2b - 6:379.2d] ***Reserved.***

6) [6:379.2e] **Exemption for certain issuer transactions approved by directors or shareholders:** With certain exceptions, SEA § 16 does *not* apply to a purchase and sale of securities between the issuer and an officer or director if the transaction was approved by the directors or a majority of the shareholders. (Reason: Any profit on such a transaction is unlikely to be at the expense of uninformed shareholders or other market participants.) [SEC Rule 16b-3(d) (17 CFR § 240.16b-3(d)); see *Dreiling v. American Express Co.* (9th Cir. 2006) 458 F3d 942, 952-955; *Levy v. Sterling Holding Co., LLC* (3rd Cir. 2008) 544 F3d 493, 500-501]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Although Rule 16b-3 requires the board to approve the transaction, it does *not* require the board to approve the transaction for the *specific purpose* of exempting it from SEA § 16(b) liability. [See *Roth v. Foris Ventures, LLC* (9th Cir. 2023) 86 F4th 832, 836-837]

State law determines whether the board of directors approved the transaction under SEC Rule 16b-3(d)(1). [*Alpha Venture Capital Partners LP v. Pourhassan* (9th Cir. 2022) 30 F4th 920, 924-928—CEO did not have to disgorge profits from short-swing transaction because quorum of board met and approved transaction by majority vote in compliance with Delaware law ("Rule 16b-3(d)(1) has no embedded requirements of unanimity, a supermajority, or a particular quorum")]

7) [6:379.3] **Exemption for securities acquired as collateral for debt:** Section 16 does *not* apply to a purchase and sale of securities "acquired in good faith in connection with a debt previously contracted." [SEA § 16(b) (15 USC § 78p(b)]

But the exemption is construed narrowly, and applies only where the acquired securities have a direct relation to the discharged debt. [See *C.R.A. Realty Corp. v. Fremont Gen. Corp.* (9th Cir. 1993) 5 F3d 1341, 1343]

Thus, a lender who obtains a security interest in shares worth more than the loan amount is not required to disgorge the profit realized when the shares are sold upon the debtor's default. But a secured lender who, in *reworking* an existing debt, voluntarily purchases and liquidates additional shares (i.e., shares exceeding the number needed to discharge the debt) is liable to the corporation for the profit realized on the *additional* shares. The additional shares do not have a direct relation to the discharged debt and thus do not fall within the exemption. [*C.R.A. Realty Corp. v. Fremont Gen. Corp.*, supra]

8) [6:379.4] **Multiple acquisitions by shareholder—"tainted" shares deemed sold:** A SEA § 16 "insider" owning existing shares who purchases and sells *additional* shares within a six-month period may *not* "trace" the sold shares to those owned *before* the six-month period. For purposes of calculating "short-swing" profits, all shares owned by the "insider" are considered fungible. To allow an "insider" to pick and choose which shares were being sold would permit easy evasion of SEA § 16(b). [See *C.R.A. Realty Corp. v. Fremont Gen. Corp.* (9th Cir. 1993) 5 F3d 1341, 1343]

➪ [6:380] ***PRACTICE POINTER:*** Section 16(b) has been referred to as a "meat axe" statute: It applies without regard to whether the trading was based on inside information, and the calculation of disgorgeable "profit" ignores loss transactions during the same period.

Recognizing this, if you represent a corporation subject to the reporting requirements of the SEA, be sure to *educate* the officers, directors and more-than-10% shareholders of the SEA § 16 implications. Also, *monitor* their compliance to guard against inadvertent violations. It is good practice to provide them with the ownership reporting forms required by SEA § 16(a) and request copies of all filings. [See SEA § 16(a) (15 USC § 78p(a))]

[6:380.1 - 6:380.5] ***Reserved.***

(d) [6:380.6] **Two-year statute of limitations:** A SEA § 16 claim must be brought within two years after the date the short-swing profit was realized. [SEA § 16(b) (15 USC § 78p(b))]

1) [6:380.7] **No automatic tolling for failure to file § 16 report:** Section 16 *might* be subject to equitable tolling: i.e., where defendant fraudulently concealed facts underlying plaintiff's SEA § 16 claim, the two-year limitations period might be tolled until such time as a reasonably diligent plaintiff discovered or should have discovered those facts. However, an insider's failure to file a § 16 report (¶ *6:378*) does *not itself* toll the two-year limitations period. [*Credit Suisse Secur. (USA) LLC v. Simmonds* (2012) 566 US 221, 225-229, 132 S.Ct. 1414, 1419-1421 (leaving open question whether 2-year statute subject to general equitable tolling)]

(e) [6:381] **Compare—Rule 10b-5:** SEC Rule 10b-5 applies to *all* securities of any issuer traded in interstate commerce; whereas SEA § 16 is limited to "short-swing" trading in equity securities issued by a 1934 Act reporting company.

To recover under Rule 10b-5, plaintiff has to prove "manipulative or deceptive conduct" by defendant, usually nondisclosure of "inside information"; whereas "short-swing" profits are recoverable under SEA § 16(b), *whether or not* attributable to undisclosed "inside information."

Finally, under 10b-5, the right of recovery belongs only to the injured purchaser or seller; whereas under § 16(b), recovery belongs to the *issuer corporation*. [See *Gollust v. Mendell* (1991) 501 US 115, 125, 111 S.Ct. 2173, 2180, fn. 7—§ 16(b) plaintiff sues solely on corporation's behalf]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b. [6:382] **California Corporate Securities Law:** Sales between private parties normally are exempt from qualification under the California Corporate Securities Law, under the "private account" exemption for nonissuer transactions. [Corps.C. § 25104(a)]

But even if the transaction is exempt from qualification, it is unlawful for "insiders" to buy or sell the corporation's securities in California when they have knowledge of material information significantly affecting the value of such securities that is not available to the public generally. (This is similar to the SEC Rule 10b5-1 "knowing possession" standard, ¶ *6:368.2j ff.*) [Corps.C. § 25402; see *Friese v. Sup.Ct. (Moores)* (2005) 134 CA4th 693, 696, 36 CR3d 558, 560]

(1) [6:383] **"Insider" defined:** Under California law, an "insider" is the issuer, or any officer, director, controlling shareholder "or any other person whose *relationship* to the issuer gives [that person] access, directly or indirectly, to material information about the issuer [that is] not generally available to the public." [Corps.C. § 25402 (emphasis added)]

(a) [6:384] **Tippees, etc.?** It is unclear whether "tippees" and remote parties would be deemed to have a "relationship to the issuer" for purposes of this section.

(b) [6:385] **Comment:** It would probably be easier to establish an action against "tippees" and other remote parties under federal law (*see*¶ *6:363 ff.*) than under California law.

While federal courts recognize *implied rights of action* against persons who violate SEC Rule 10b-5 (*see*¶ *6:360*), California courts cannot similarly imply rights of action for violations of the Corporate Securities Law. The Code specifically provides: "… [N]o civil liability … shall arise against any person by implication from … violation of any provision of this law …" [Corps.C. § 25510]

[6:385.1 - 6:385.4] ***Reserved.***

(c) [6:385.5] **No "misappropriation" liability:** Unlike federal SEC Rule 10b-5 (*see*¶ *6:367 ff.*), there is no liability under California law for securities trading based on "misappropriated" nonpublic information.

(2) [6:386] **Who may recover:** Like federal SEC Rule 10b-5, only a *purchaser or seller* of a security (or the issuer, ¶ 6:388.1) may recover for violation of the California law. [Corps.C. § 25502]

(3) [6:387] **Privity required:** However, unlike SEC Rule 10b-5 actions, *privity is required:* i.e., plaintiffs can recover only from the person from whom they purchased, or to whom they sold, the securities in question. (This requirement severely limits Corps.C. § 25502 actions.) [Corps.C. § 25502; see *Friese v. Sup.Ct. (Moores)* (2005) 134 CA4th 693, 704, 36 CR3d 558, 566]

Moreover, there are *no* "implied" causes of action against "tippees" or other remote parties under California law. [See Corps.C. § 25510, ¶ *6:385*]

[6:387.1 - 6:387.4] ***Reserved.***

(4) [6:387.5] **Exception for trades pursuant to prior contract or plan or by entity having established safeguards:** An insider is deemed *not* to have traded with knowledge of material inside information (¶ *6:382 ff.*), and hence no liability attaches, if the trade complied with SEC Rule 10b5-1(c) (trading pursuant to prior binding contract or plan (¶ *6:368.2k*) or by employee of entity having reasonable policies and procedures to prevent use of material nonpublic information (¶ *6:368.2l*)). [Commr. Rule 260.402]

(5) [6:388] **Relief available:** The remedy for trading on inside information is *damages:* the difference between the purchase or sale price and the value the security would have had if the information had been disclosed, plus interest. [Corps.C. § 25502]

(a) [6:388.1] **Treble damages for public corporation:** An *insider* (¶ *6:383*) of a corporation with over $1 million in *total assets* and *500 or more* record holders of a class of equity securities who is guilty of insider trading is liable *to the corporation* for *treble damages*—i.e., up to three times the difference between the price at which the security was purchased or sold and the value it would have had if the information had been disclosed—plus interest, costs and attorney fees. [Corps.C. § 25502.5(a), (d)]

1) [6:388.2] **Purpose:** The corporation need *not* show harm from the insider trader's activities. Corps.C. § 25502.5 is a disgorgement statute: Its purpose is not to remedy injury to the corporation but, rather, to *deter corporate insiders from trading on inside information*, and thus to promote investor confidence in the securities market. [*Friese v. Sup.Ct. (Moores)* (2005) 134 CA4th 693, 696, 705-706, 709-710, 36 CR3d 558, 560, 567, 570-571]

2) [6:388.3] **Set-offs:** The corporation's recovery is reduced by any damages defendant paid with respect to the same illegal transaction under any other statute—e.g., the Federal Insider Trading Sanctions Act (*¶ 6:374.1*). [Corps.C. § 25502.5(b)]

3) [6:388.4] **Derivative action to enforce:** A shareholder may bring a derivative action to enforce the corporation's treble damages claim. Where demand is made on the board (*¶ 6:622*), the board must "consider the allegation in good faith." And, if the shareholder demand alleges misconduct by any director, that director may not vote on the matter (but may be counted toward a quorum). [Corps.C. § 25502.5(a), (c)]

4) [6:388.5] **Applicable to foreign corporation insiders:** California's statutory prohibition on insider trading is not limited to insiders of California corporations; it also applies to insiders of foreign corporations present in California. [Corps.C. § 25402; *Friese v. Sup.Ct. (Moores)* (2005) 134 CA4th 693, 696, 704, 36 CR3d 558, 560, 566]

Liability cannot be avoided under the umbrella of Corps.C. § 2116, which provides that foreign corporation directors are liable to the corporation for breach of their official duty according to the laws of the state of incorporation (*¶ 3:4.3*): Corps.C. § 2116 does not override statutes such as Corps.C. §§ 25402 and 25502.5 imposing liability in *securities* transactions. [*Friese v. Sup.Ct. (Moores)*, supra, 134 CA4th at 706-708, 36 CR3d at 567-569—Corps.C. §§ 25402 and 25502.5 applied to directors who used inside information to sell their stock in publicly-traded Delaware corporation that had its headquarters and principal place of business in California; but see *In re Sagent Tech., Inc. Derivative Litig.* (ND CA 2003) 278 F.Supp.2d 1079, 1090-1092—restrictions on directors' purchases and sales of stock in Delaware corporation are "internal affairs" governed by Delaware law under Corps.C. § 2116 and hence Corps.C. § 25402 does not apply; *In re Wells Fargo & Co. Shareholder Derivative Litig.* (ND CA 2017) 282 F.Supp.3d 1074, 1110-1112 (*Sagent Tech.*, supra, followed)]

(b) [6:389] **Compare—rescission:** Rescission is available as an alternative remedy only if the "insider" made affirmative misrepresentations (i.e., untrue statements), or failed to disclose facts necessary to prevent the statements made from being misleading. *Material*, "inside" information would almost certainly fall in this category. [Corps.C. §§ 25401, 25501; *also see¶ 5:400 ff.* re defenses]

(c) [6:389.1] **Compare—criminal penalties:** Persons who willfully violate these rules risk fines of up to $10,000,000 ($25,000,000 for certain violations by a 1934 Act reporting company) and imprisonment of up to five years. [Corps.C. § 25540(a)-(c); *see¶ 5:431 ff.*]

c. [6:390] **Common law liability:** Before enactment of the Corporate Securities Law, California cases recognized a common law cause of action based on insider trading. Corporate directors, officers, and other insiders were under a duty to disclose "inside" information to the parties with whom they dealt whenever "*special facts*" made it "*inequitable*" for them to buy or sell without such disclosure. [See *Taylor v. Wright* (1945) 69 CA2d 371, 381-382, 159 P2d 980, 985—directors concealed their identity and refused to disclose the real value of stock they purchased from widow in direct negotiations]

Presumably, the above common law cause of action is still available. (Corps.C. § 25510 states that "Nothing in this chapter shall limit any liability which may exist by virtue of … common law.")

If so, then liability based on the "special facts approach" can be invoked as an alternative to an action under the California law; and would be available in cases otherwise not actionable under the federal or state securities law.

[6:390.1 - 6:390.4] ***Reserved.***

➪ [6:390.5] ***PRACTICE POINTERS:*** To minimize the possibility of illegal insider trading, the company should establish a *compliance program* containing the elements described below (¶ 6:390.6 ff.). (Indeed, a properly-structured program may eliminate *corporate* liability under SEC Rule 10b-5 in circumstances where an "insider" trades without knowledge of material inside information that is known to others in the company; *see¶ 6:368.2l*.)

• [6:390.6] ***Appointment of compliance officer*:** The company should require all personnel to clear their trades in advance with corporate counsel or a designated compliance officer who would also be responsible for preparing any necessary securities reports or filings.

• [6:390.7] ***Prompt disclosure of developments:*** Companies should disclose material information promptly to avoid the possibility of leaks. When secrecy is required, information should be restricted to those persons having a need to know.

• [6:390.8] ***Blackout periods and trading windows:*** If the company is in the midst of material developments, it should be prepared to impose a "blackout period" during which insider trading is forbidden. Indeed, the company may wish to

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

consider the common measure of permitting insiders to trade only during “window periods,” such as following an earnings announcement or filing and publication of a quarterly or annual report.

• [6:390.9] ***Educating company personnel:*** Of course, insiders must be informed of the prohibitions against insider trading. The company should adopt and disseminate a written policy regarding insider trading and require all employees to acknowledge receipt of it.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 6-F

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

F. Particular Operating Problems

- 1. [6:391] Compensation of Officers and Directors
  - a. [6:392] Duration of employment
    - (1) [6:393] Power of board to bind corporation beyond board's own term
      - (a) [6:394] Effect of bylaws limitation
    - (2) [6:395] Compare—bylaws stating duration of employment
    - (3) [6:396] Compare—statutory limit on duration
    - (4) [6:397] Limitation—"waste"
  - b. [6:398] Designation of officership status
    - (1) [6:399] Right to remove from office
    - (2) [6:400] Compare—enforcement of shareholder agreements
  - c. Covenants not to compete
    - (1) [6:401.1] Generally void in California
      - (a) [6:401.1a] Partial restrictions also void
      - (b) [6:401.1b] Required notice by employer of void noncompete agreement
      - (c) [6:401.1c] Enforcement of prohibition
      - (d) [6:401.1d] Reasonableness standard applies to noncompete agreements outside employment context
      - (e) [6:401.1e] Ethical violation for attorneys
    - (2) Exceptions
      - (a) [6:401.2] Covenants not to compete by selling shareholders
        - 1) [6:401.3] Effect
      - (b) [6:401.4] Nonsolicitation agreements
      - (c) [6:401.5] Current employees
    - (3) Out-of-state contracts involving California businesses and/or workers
      - (a) [6:401.8] Noncompetition covenant not binding on California hirers
        - 1) [6:401.8a] Comment
      - (b) [6:401.10] Compare—limited noncompetition clause in contract requiring arbitration of disputes
    - (4) [6:401.15] Compare—federal law banning noncompete clauses
      - (a) [6:401.16] "Worker"
      - (b) [6:401.17] Application to "senior executives"
      - (c) [6:401.18] "Noncompete clause"
      - (d) [6:401.19] Exceptions
      - (e) [6:401.20] Notice requirements

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(f) [6:401.21] State law preempted
(g) [6:401.22] Severability
d. [6:402] Compensation
(1) Nature of services rendered
(a) [6:403] Directors
1) [6:404] Compare—“extraordinary” services
2) [6:404.1] Comment
(b) [6:405] Officers
(2) [6:406] Types of compensation, generally
(3) [6:406.1] Employee stock option or purchase plans as compensation
(a) [6:406.2] Typical features
(b) [6:406.3] Shareholder approval
(c) [6:406.4] Loan approval by board alone
(d) [6:406.6] ERISA plans—trustee's standard of prudence
1) [6:406.7] Special concerns where trustee possesses “inside information”
2) [6:406.8] Plan participants' standing to sue for mismanagement
(4) [6:407] Tax considerations
(a) [6:408] Immediate deductions and no taxable income
(b) [6:410] Immediate deductions and deferred income
(c) [6:412] Immediate deduction and immediate income
(d) [6:413] Deferred deduction and deferred income
(e) [6:414] No deduction and deferred income
1) [6:414a] Comment
(5) [6:414.1] Securities law requirements
(a) Compliance with federal securities laws
1) [6:414.2] Employee stock options
2) [6:414.3] Employee stock purchase plans
3) [6:414.4] Exemptions from registration
4) [6:414.4a] Executive compensation “clawback” for financial statement irregularities (“listed” companies)
(b) [6:414.5] Compliance with California securities laws
1) Exemptions from qualification
a) [6:414.6] Rule 701 exempt securities
b) [6:414.7] “Limited offering” exemption
c) [6:414.8] Exemption for reporting company incentive stock options
(6) [6:415] “Reasonableness” as limitation
(a) [6:416] As limit on deductibility
1) [6:417] Test
2) [6:418] Excessive salaries as constructive dividends
3) [6:419] Effect of “repay” agreements
a) [6:420] Caution—“red flag” to IRS
4) [6:420.5] No deduction for public corporation executive pay over $1 million
a) [6:420.6] Maximum deduction applies to 5 covered employees until 2027
b) [6:420.7] Maximum deduction will apply to 10 covered employees beginning in 2027
(b) [6:421] As “waste” of corporate assets
1) [6:422] Test
2) Application
a) [6:423] Services previously rendered
b) [6:424] Departure bonuses

- c) [6:425.1] "Golden parachutes"
  - 1/ [6:425.2] Tax limitations
  - 2/ [6:425.2a] "Disqualified individuals" defined
  - 3/ [6:425.3] Exceptions for small companies
- d) [6:426] Uncertain future services
- (7) [6:427] Conflict of interest as limitation
  - (a) [6:428] Comment
  - (b) [6:429] "Interested" director may attend meeting
  - (c) [6:430] "Interested" director's vote not counted
    - 1) [6:431] Compare—mutual "back scratching" permitted
  - (d) [6:432] Effect of approval by shareholders or directors
    - 1) [6:433] "Reasonableness"
    - 2) [6:434] Burden of proof re "reasonableness"
- 2. [6:436] Indemnification of Officers and Directors
  - a. [6:437] Statute as limit on indemnification
    - (1) [6:437.1] Compare—contractual indemnification
    - (2) [6:438] Compare—insurance coverage
    - (3) [6:438.1] Compare—indemnification for securities law violations
    - (4) [6:438.2] Compare—indemnification for ERISA liabilities
  - b. [6:439] When indemnification *mandatory*
    - (1) [6:440] Purpose
      - (a) [6:440a] Option to forgo corporate indemnification
      - (b) [6:440.1] Includes corporate employees sued by corporation
    - (2) [6:440.5] Defendant must have acted on behalf of corporation
    - (3) [6:441] Successful defense on merits required
      - (a) [6:441.1] Lack of liability as determination on merits
      - (b) [6:441.5] Compare—termination of administrative or investigative proceeding
      - (c) [6:442] Compare—no mandatory indemnification following dismissal pursuant to settlement
    - (4) [6:443] Partial judgments
    - (5) [6:443.5] Officer's or director's "good faith" not an issue
    - (6) [6:444] Expenses
  - c. [6:445] When indemnification *permissible*
    - (1) [6:446] In litigation other than suits by or on behalf of corporation
      - (a) [6:446.1] Defendant must have acted on behalf of corporation
      - (b) [6:447] Good faith requirement
        - 1) [6:448] No presumption of bad faith by reason of defeat
      - (c) [6:449] Expenses *and* liabilities
        - 1) [6:450] Expenses in defending proceeding
        - 2) [6:451] Expenses in establishing right to indemnification
        - 3) [6:452] Liabilities
          - a) [6:453] May be waived
    - (2) [6:454] Derivative suits and direct actions by corporation
      - (a) [6:454.1] Indemnification mandatory where defendant prevails
      - (b) Settlement of threatened or pending derivative suit
        - 1) [6:455] Threatened suits
        - 2) [6:456] Pending suits
          - a) [6:456.1] Expenses and settlement costs
        - 3) [6:457] "Good faith"
      - (c) [6:458] Judgment against defendant

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(d) [6:459] Indemnification of corporate officer as *plaintiff?*
(3) [6:459.1] Compare—insolvent corporations
d. [6:459.5] Indemnification of "agents"
(1) [6:459.6] Comment
e. [6:460] How authorized
(1) [6:461] Board action
(2) [6:461.1] By independent counsel
(3) [6:462] Shareholder action
(4) [6:463] Court order
(a) [6:464] Comment
f. [6:464.1] Indemnification *exceeding* statutory limits
(1) Limitations
(a) [6:464.2] Indemnification prohibited by statute
(b) [6:464.3] Highly culpable misconduct
(2) [6:464.4] Comment—limited application of "expanded" indemnification rights
(a) [6:464.5] Public corporations main beneficiaries
g. [6:464.10] No "vesting" of indemnification rights
h. [6:465] Compare—advancing defense costs
i. [6:466] Compare—liability insurance ("D & O coverage")
(1) [6:467] Comment
(2) [6:468] Coverage limited
(3) [6:470.1] Corporation can control insuring company
(a) [6:470.2] Authorized in articles
(b) [6:470.3] Not authorized by articles
1) [6:470.4] Comment
3. [6:471] Borrowing and Lending
a. [6:472] Loans or guarantees for officers and directors
(1) [6:473] "Shareholder approval"
(a) [6:473.1] Shares held by interested officers and directors not counted
(b) [6:473.2] Interested officers' and directors' shares counted in determining quorum
(c) [6:473.3] Lack of majority
(d) [6:473.4] Effect of articles provisions
(e) [6:474] Compare—interested nonofficer or nondirector shareholders entitled to vote?
(2) [6:475] Compare—employee stock purchase loans
(3) [6:475.1] Compare—loans from other employee benefit plans
(4) [6:476] Compare—officer-loans by corporations with 100 or more shareholders
(5) [6:478] Compare—certain advances not requiring shareholder approval
(6) [6:478.1] Other loan transactions excluded
(7) [6:479] Directors personally liable where requisite shareholder approval not obtained
(8) [6:480] Tax considerations
(9) [6:482.5] *Caution*—no loans by public corporations
b. [6:483] Loans or guarantees secured by corporation's shares
c. [6:484] Corporate borrowings
(1) [6:485] Authorization
(2) [6:487] Liability of shareholders, insiders
(3) [6:491] Borrowing from insiders
(a) [6:492] Conflict of interest
(b) [6:493] Tax considerations—"debt" vs. "equity"
4. [6:494] Corporate Records

- a. [6:495] Records required by statute
- b. [6:500] Directors' inspection rights
  - (1) [6:501] Which corporations
  - (2) [6:502] Enforcement by court action
    - (a) [6:502.1] Court-imposed limits on inspection rights
      - 1) [6:502.2] Breach of fiduciary duty causing harm to corporation
      - 2) [6:502.3] Documents covered by corporate attorney-client privilege
  - (3) [6:503] Validity of limitations imposed by articles/bylaws
  - (4) [6:503.5] Compare—former directors
    - (a) [6:503.6] Inspection rights where former director faces potential liability
- c. [6:504] Shareholder inspection rights
  - (1) [6:505] Bylaws
  - (2) [6:506] Accounting books, corporate records and shareholder and director minutes
    - (a) [6:507] Which corporations
      - 1) [6:507.1] Effect of internal affairs doctrine
        - a) [6:507.2] Caution—subject to internal affairs doctrine in Delaware
    - (b) [6:507.3] Who can exercise shareholder inspection rights
      - 1) [6:507.4] Beneficial owners are excluded
    - (c) [6:508] Which records
      - 1) [6:508.1] Form of records
      - 2) [6:509] Compare—directors' inspection rights
      - 3) [6:509.1] Common law inspection rights
      - 4) [6:510] Federal income tax returns accessible by 1% shareholder
      - 5) [6:510.1] Privacy rights of corporate personnel and other shareholders
    - (d) [6:511] What purposes
      - 1) [6:512] Examples
      - 2) [6:513] Comment
      - 3) [6:514] Impact of corporation having furnished audited statements
    - (e) [6:515] Mechanics of inspection
      - 1) [6:515.1] Location
    - (f) [6:516] Enforcement by court action
      - 1) [6:517] Expenses
      - 2) [6:518] Statutory penalty
    - (g) [6:519] Validity of limitations
  - (3) [6:520] Minutes of shareholders' or directors' meetings
  - (4) [6:522] List of shareholders
    - (a) Which shareholders entitled to inspect
      - 1) [6:523] Shareholders with 5% or more voting shares
      - 2) [6:524] Shareholders with less than 5% voting shares
        - a) [6:525] Compare—Delaware law
    - (b) [6:526] Which corporations
      - 1) [6:527] Constitutionality upheld
    - (c) [6:528] Mechanics of inspection
    - (d) [6:531] Enforcement by court action
      - 1) [6:532] Procedure
      - 2) [6:533] Order postponing meetings
      - 3) [6:534] Order for inspection
      - 4) [6:535] Expenses
      - 5) [6:537] Statutory penalty

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(e) [6:538] Validity of limitations
(f) [6:538.1] Shares held in "street name"—duty to produce names of beneficial owners?
1) [6:538.2] Comment
(5) [6:538.6] Communications with corporation's attorneys
5. [6:539] Reports
a. [6:540] Annual report to shareholders
(1) [6:541] How provided
(2) [6:542] When report due
(3) [6:543] Contents of report
(a) [6:544] Additional disclosures required for certain corporations
(b) [6:547] Accounting standards
1) [6:548] Compare—corporations with less than 100 shareholders
(4) [6:549] Certification
(5) [6:550] Annual report upon request
(6) [6:552] Quarterly reports upon request
(7) Enforcement by shareholder's suit
(a) [6:554] Injunction
(b) [6:555] Expenses
(c) [6:556] Statutory penalty
(8) [6:556.5] Annual benefit report (benefit corporations)
b. [6:557] Annual information statement to Secretary of State
(1) [6:558] Form and fee
(2) [6:559] Purpose
(3) Enforcement provisions
(a) [6:560] Statutory penalty
(b) [6:561] Suspension
(c) [6:561.1] Reinstatement
c. [6:561.6] Correction of false or misleading reports by publicly-held corporation
6. [6:562] Suspension of Corporate Powers
a. [6:563] Effect of suspension
(1) [6:564] Incapacity to sue or defend in court
(a) [6:564.1] Waiver of incapacity defense by failure to timely assert
1) [6:564.2] Untimely assertion of defense in response to discovery motion
2) [6:564.2a] Exception where corporation refuses to pay delinquent taxes
3) [6:564.2b] Standing to sue distinguished
(b) [6:564.4] Corporate counsel's duty to notify court of suspension
(c) [6:564.5] Service of process unaffected by suspension
(d) [6:564.6] Statute of limitations runs during suspension
(e) [6:564.7] Court's jurisdiction to grant relief to adverse party not affected by corporation's suspension
(f) [6:564.11] Limitation—intervention by insurer
1) [6:564.12] Reason
2) [6:564.13] Distinguish—no subrogation by insurer
(g) [6:565] Compare—derivative suit against officers preventing reinstatement
(h) [6:565.1] Compare—suit by third-party beneficiary of corporate contract
(i) [6:565.2] Continuance to effect reinstatement
(2) [6:565.3] Cannot engage in real estate transactions
(3) [6:566] Contracts voidable
(a) [6:566.1] Limitation—court-ordered rescission required

(b) [6:566.2] Relief from voidability
(4) [6:566.3] Cannot claim escheated property
(5) [6:566.4] Potential loss of corporate name
(6) [6:567] Potential administrative dissolution by Secretary of State where corporation suspended at least 60 months
b. [6:568] Reinstatement (revivor)
(1) [6:568.1] "Substantial compliance" rule
(2) [6:569] Who may reinstate
(3) [6:570] Clearance of corporate name
(4) [6:571] Conditional reinstatement
(5) [6:572] Effect of reinstatement
(a) [6:572a] Rationale
(b) [6:572.1] Voidable contracts subject to "validation"
1) [6:572.1a] Relief from voidability need not be sought simultaneously with revivor
2) [6:572.2] Penalties
c. [6:573] Compare—forfeiture for failure to pay franchise taxes for five years
7. [6:574] Share Transfers
a. [6:575] Restrictions on right to transfer
(1) [6:576] Articles
(a) [6:576.1] "Reasonableness" of restriction
(2) [6:577] Bylaws
(3) [6:578] Shareholder agreements
(a) [6:579] Enforcement
(b) [6:580] Comment
(4) [6:581] Close corporation share certificate
(5) [6:582] Requirements of California Securities Law
(a) [6:582.1] Transfers benefiting corporation treated as issuer transactions
1) [6:582.2] Example
2) [6:582.3] Transfer of legended shares benefiting corporation
(b) [6:582.4] Commissioner's consent required for other transfers
1) [6:582.5] Procedure for obtaining consent to transfer
2) [6:583] Compare—certain transfers not requiring consent
(6) [6:584] Requirements of federal securities laws
(a) [6:585] "Safe harbor" rules
b. [6:586] Procedure for obtaining Financial Protection and Innovation Commissioner's consent
(1) [6:587] Application
(2) [6:587.1] Filing fee
(3) [6:588] Legend restricting further transfer
(4) [6:589] When qualification required—public offerings in nonissuer transactions
(a) [6:590.1] Qualification standards in nonissuer transactions
1) [6:590.2] Nonqualifiable securities
2) [6:590.3] Issuer may not be a "shell" company
(b) [6:590.4] Exemption for Rule 144A resales
c. [6:591] Procedure for transfer by corporation
(1) [6:591a] Compare—share reacquisition by corporation
(2) [6:591.1] Compare—uncertificated shares
(a) [6:591.2] Additional requirements for blockchain system
(b) [6:591.3] Shares held by securities intermediary
(3) [6:592] Statutory penalty for failure to transfer shares

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- (4) [6:592.1] Immunity from liability for certain transfers
  - (a) [6:592.6] Immunity not affected by other Code provisions
- d. [6:593] Effect of transfer of unpaid shares
- e. [6:595] Transfers affecting corporate status
- f. [6:597a] Transfers triggering corporate realty reassessment and potential transfer tax

8. [6:597f] Corporation's Punitive Damages Liability for Employee's Acts
- a. [6:597g] “Managing agent”
- b. [6:597h] “Ratification”

9. [6:597.1] CERCLA Liability
- a. [6:597.1a] Individual liability for corporation's violations
  - (1) [6:597.1b] Corporate indemnification
- b. [6:597.2] Parent's liability for subsidiary's violations
  - (1) [6:597.3] Veil piercing governed by state or federal law?
- c. [6:597.5] Successor liability
- d. [6:597.5e] No CERCLA preemption of state limitations period for suits against dissolved corporation

10. [6:597.5i] Delivery to State (Escheat) of Unclaimed Corporate Shares, Bonds and Distributions
- a. [6:597.5j] Applicable primarily to California shareholders/bondholders
- b. [6:597.5k] Notice to shareholder/bondholder prior to escheat
- c. [6:597.5*l*] Report and payment to California Controller
  - (1) [6:597.5m] Stock transfer
    - (a) [6:597.5n] Immunity from liability

11. [6:597.6] California Corporate Criminal Liability Act of 1989
- a. [6:597.7] Disclosure requirements
  - (1) [6:597.8] Exception
  - (2) [6:597.9] Use of notice in subsequent criminal actions
- b. [6:597.10] Penalties

12. [6:597.20] Ratification and Judicial Validation of Noncompliant Corporate Actions
- a. Ratification by corporation
  - (1) [6:597.21] Approval
  - (2) [6:597.22] Resolutions for actions not related to election of initial directors
    - (a) [6:597.23] *Caution—corporate actions re share issuance*
  - (3) [6:597.24] Resolutions for actions related to election of initial directors
  - (4) [6:597.25] Notice of ratification
  - (5) [6:597.26] Certificate of ratification
    - (a) [6:597.27] Contents
    - (b) [6:597.28] Filing or refusal to file by Secretary of State
- b. [6:597.40] Judicial validation
  - (1) [6:597.41] Persons authorized to file petition
  - (2) [6:597.42] Proper county for filing
  - (3) [6:597.43] Time for filing
    - (a) [6:597.44] Exceptions
  - (4) [6:597.45] Service of petition
  - (5) [6:597.46] Notice to other persons; intervention
  - (6) [6:597.47] Identification of other pending legal proceedings
  - (7) [6:597.48] Certificate of validation
- c. [6:597.60] Limitations on ratification and validation rights
  - (1) [6:597.61] Dissolved or foreign corporations
  - (2) [6:597.62] Prohibition on ratification or validation of specified actions
- d. [6:597.63] Relation back

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

e. [6:597.64] Retention of records
f. [6:597.65] Stay of ratification or validation due to pending proceedings

1. [6:391] **Compensation of Officers and Directors:** A variety of arrangements may be utilized for compensating the officers and directors for their services: e.g., formal employment agreements, stock option plans, retirement and employee benefit plans, etc. Following are the issues most commonly encountered in connection with such compensation arrangements:

a. [6:392] **Duration of employment:** First of all, there may be questions as to the permissible duration of any employment contract. Often, the board of directors may want to offer key personnel or managing officers employment contracts extending beyond the board's own term of office (i.e., more than one year). Moreover, long-term employment contracts are sometimes foisted on a corporation by management seeking to perpetuate itself in office—so-called "golden parachutes" to protect management in the event of an unfriendly corporate takeover.

(1) [6:393] **Power of board to bind corporation beyond board's own term:** Unless the articles or bylaws provide otherwise, the board of directors *has* power to bind the corporation *contractually* beyond the directors' own term of office (e.g., employment contracts for longer than one year).

This does not mean, of course, that future boards cannot fire or remove from office employees or officers appointed by earlier boards. But such termination would have no effect on the employee's *contractual* rights against the corporation (i.e., to recover damages for breach of employment agreement).

(a) [6:394] **Effect of bylaws limitation:** Articles or bylaws provisions could seek to limit the board's contracting powers to the board's own term of office.

But such provisions are rare, and would have no effect on the contract rights of an officer or employee who did not know of the limitation. [See Corps.C. § 208(a), (b); ¶ *4:19*]

Moreover, directors normally have power to *amend* the bylaws (*see*¶ *4:177*). Thus, their approving a contract extending beyond their own term of office might be upheld on the theory that it was an "implied amendment" of the bylaws. [*Realty Acceptance Corp. v. Montgomery* (3rd Cir. 1930) 51 F2d 636, 638; *United Producers & Consumers Co-op. v. Held* (9th Cir. 1955) 225 F2d 615, 617-618]

(2) [6:395] **Compare—bylaws stating duration of employment:** If the corporate bylaws fix the term of an officer's employment, that provision may be "read into" the employment contract so as to be binding on the corporation. [See *Hillsman v. Sutter Comm. Hospitals* (1984) 153 CA3d 743, 753-755, 200 CR 605, 611-613]

Further, bylaw provisions may specify the *grounds* and *procedures* that must be followed by the corporation to terminate employment or officership status. Again, these will ordinarily be "read into" the employment contract and will be binding on the corporation. [*Hillsman v. Sutter Comm. Hospitals*, supra]

(3) [6:396] **Compare—statutory limit on duration:** The only applicable statutory limit is that corporate employment contracts cannot be enforced *against the employee* beyond 7 years from the date the employment begins. [Lab.C. § 2855(a)]

But this does not limit the employee's rights against the corporation. An action for damages might lie against the corporation for breach of a contract for 10 years, 20 years or even "lifetime" employment—even though it could not be enforced against the employee after seven years.

(4) [6:397] **Limitation—"waste":** Arguably, the only real limitation on the duration of a corporate employment contract is the fiduciary obligation owed by directors not to "waste" corporate assets (*see*¶ *6:244, 6:421*).

b. [6:398] **Designation of officership status:** Sometimes, an employment contract specifies that the person is employed as "president" or "chief financial officer," etc., of the corporation. Board approval of such a contract is tantamount to election or appointment by the directors of such person to the office designated.

(1) [6:399] **Right to remove from office:** An employment contract designating an officership does *not* necessarily insure that the person will remain in office. Corporate officers serve at the pleasure of the board, and therefore can be removed at any time, even if such removal violates the employment contract and exposes the corporation to liability for breach of contract damages. [Corps.C. § 312(b); ¶ *6:266*]

(2) [6:400] **Compare—enforcement of shareholder agreements:** The result may be different where shareholders of closely-held corporations have entered into agreements to cause the corporation to employ each of them as officers. Such agreements may be *specifically enforceable*. In appropriate cases, the shareholders can be compelled to vote their shares so as to elect directors who will retain them in the offices designated.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

➪ [6:401] ***PRACTICE POINTER:*** In drafting an employment contract on behalf of the corporation, be sure to *spell out the duties* of the office, rather than simply designate the office to be filled. An agreement stating only that the person is employed as "president" or "general manager" or "chief financial officer," provides no clear standards as to what services the employee is obligated to perform.

c. Covenants not to compete

(1) [6:401.1] **Generally void in California:** Some corporate employers may wish to include a covenant in employment contracts barring employees from competing with the corporation after the employment contract's termination or the employee's discharge for cause. With limited exceptions (*see ¶ 6:401.2 ff.*), such covenants are *void* in California to the extent the employee would be "restrained from engaging in a lawful profession, trade, or business of any kind" regardless of whether the person being restrained is a party to the contract, where and when the contract was signed, and whether the employment was maintained outside of California. [Bus. & Prof.C. §§ 16600(a) (subd. relettered Stats. 2023, Ch. 828; eff. 1/1/24), 16600.1 (added Stats. 2023, Ch. 828; eff. 1/1/24), 16600.5 (added Stats. 2023, Ch. 157; eff. 1/1/24); see *Edwards v. Arthur Andersen LLP* (2008) 44 C4th 937, 948-950, 81 CR3d 282, 292-294; see also *AMN Healthcare, Inc. v. Aya Healthcare Services, Inc.* (2018) 28 CA5th 923, 935-936, 239 CR3d 577, 587-588; *Robinson v. U-Haul Co. of Calif.* (2016) 4 CA5th 304, 316, 209 CR3d 81, 90, fn. 5; compare *NuVasive, Inc. v. Miles* (Del.Ch. 2018) 2018 WL 4677607 (unpub.) —contract provision applying Delaware law to California resident's employment agreement containing provision not to compete with employer for 1 year after termination of employment valid in view of Lab.C. § 925 (but subsequently finding contract provision unenforceable because resident not represented by counsel as required by Lab.C. § 925(e) (*NuVasive, Inc. v. Miles* (Del.Ch. 2019) 2019 WL 4010814, *3-7 (unpub.))) (also finding covenants not to solicit employer's customers and employees for 1 year after employee's termination were unenforceable, since California's strong public policy (Bus. & Prof.C. § 16600) in overseeing employment conditions in California outweighed Delaware's fundamental, but more general, interest in freedom of contract)]

Bus. & Prof.C. § 16600 is to be read broadly, in accordance with *Edwards v. Arthur Anderson LLP*, supra, "to void the application of any noncompete agreement in an employment context, or any noncompete clause in an employment contract, *no matter how narrowly tailored*, that does not satisfy an exception in [Bus. & Prof.C., Div. 7, Part 2, Ch. 1]." [Bus. & Prof.C. § 16600(b) (emphasis added) (also stating subdivision is declaratory of existing law)]

(a) [6:401.1a] **Partial restrictions also void:** Covenants rendered unenforceable by Bus. & Prof.C. § 16600 are not limited to those that totally bar an employee from engaging in their occupation or those that are unreasonable or overbroad. Even narrowly tailored restraints (e.g., duration) imposing only *partial* restrictions on a former employee's ability to pursue a lawful profession, trade, or business are void. [*Dowell v. Biosense Webster, Inc.* (2009) 179 CA4th 564, 575-576, 102 CR3d 1, 8-9; *Edwards v. Arthur Andersen LLP*, supra (rejecting Ninth Circuit cases that misinterpreted California law to allow "narrow restraints"); see *D'Sa v. Playhut, Inc.* (2000) 85 CA4th 927, 929, 102 CR2d 495, 497—employer wrongfully discharged employee for refusing to sign employment agreement containing noncompete clause; and *Golden v. California Emergency Physicians Med. Group* (9th Cir. 2018) 896 F3d 1018, 1021-1028—agreement settling racial discrimination claims violated § 16600 where agreement required plaintiff physician to waive rights to employment with former employer (consortium of nearly 2,000 physicians managing or staffing emergency rooms throughout Calif. and in other western states) or with any facility in which former employer contracted to provide services]

(*Compare:* Competing with the corporation *while employed by it* is a clear conflict of interest; *see¶ 6:328*.)

(b) [6:401.1b] **Required notice by employer of void noncompete agreement:** For current employees (and former employees who were employed *after January 1, 2022*), whose contracts include noncompete clauses that do not satisfy an exception, the employer must, *by February 14, 2024*, notify the employee that the noncompete clause or noncompete agreement is void. The notice must be a "written individualized communication" to the employee and must be delivered to the employee's last known address and their email address. [Bus. & Prof.C. § 16600.1 (added Stats. 2023, Ch. 828; eff. 1/1/24)]

(c) [6:401.1c] **Enforcement of prohibition:** An employer that enters into a void noncompete agreement, or attempts to enforce such an agreement, commits a civil violation, and an affected employee (or former or prospective employee)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

may bring an action for injunctive relief, damages, or both, including reasonable attorney fees and costs. [Bus. & Prof.C. § 16600.5 (added Stats. 2023, Ch. 157; eff. 1/1/24); see Bus. & Prof.C. § 16600.5(d), (e)]

(d) [6:401.1d] **Reasonableness standard applies to noncompete agreements outside employment context:** The *Edwards* holding (¶ 6:404.1) is limited to employment-related noncompetition agreements. To determine whether noncompetition agreements outside the employment context are valid under Bus. & Prof.C. § 16600, courts will apply a reasonableness standard and ask "whether an agreement harms competition more than it helps" based on "the facts peculiar to the business in which the restraint is applied, the nature of the restraint and its effects, and the history of the restraint and the reasons for its adoption." [*Ixchel Pharma, LLC v. Biogen, Inc.* (2020) 9 C5th 1130, 1150-1151, 266 CR3d 665, 677-678 (internal quotes omitted)]

Note: The Court expressly stated that its decision in *Ixchel Pharma* does "not disturb the holding in *Edwards* and other decisions strictly interpreting [Bus. & Prof.C.] section 16600 to invalidate noncompetition agreements following the termination of employment or sale of interest in a business." The Court emphasized the "policy considerations specific to employment mobility and competition" cited in *Edwards* to distinguish employment-related noncompetition agreements. [*Ixchel Pharma, LLC v. Biogen, Inc.*, supra, 9 C5th at 1158-1159, 266 CR3d at 684-685; see also *Quidel Corp. v. Sup.Ct. (Beckman Coulter, Inc.)* (2020) 57 CA5th 155, 172, 271 CR3d 237, 250—agreement prohibiting manufacturer from researching or developing specific laboratory analyzer subject to rule of reason and not per se invalid "[b]ecause the rule announced in *Edwards* does not extend beyond the employment context"]

(e) [6:401.1e] **Ethical violation for attorneys:** The California Rules of Professional Conduct prohibit attorneys from covenanting not to provide legal services to clients of their former employer. [See CRPC 5.6 (a) (formerly CRPC 1-500(A))]

(2) Exceptions

(a) [6:401.2] **Covenants not to compete by selling shareholders:** Noncompetition agreements *are* enforceable as to shareholders selling or otherwise disposing of *all* their shares. [Bus. & Prof.C. § 16601; *Hilb, Rogal & Hamilton Ins. Services of Orange County, Inc. v. Robb* (1995) 33 CA4th 1812, 1824-1825, 39 CR2d 887, 894—exchange of shares in merger constituted § 16601 sale or disposition; *see further discussion at¶ 8:118.14 ff.*]

But this exception is limited to shareholders who have a "substantial interest in the corporation," so that the sale constitutes a transfer of the corporation's *goodwill*. Reason: The exception is meant to help owners of small business corporations obtain a higher price for their shares by permitting them to agree not to compete after selling all their shares. [*Hill Med. Corp. v. Wycoff* (2001) 86 CA4th 895, 904-908, 103 CR2d 779, 786-789; *Bosley Med. Group v. Abramson* (1984) 161 CA3d 284, 290, 207 CR 477, 481; see *Vacco Indus., Inc. v. Van Den Berg* (1992) 5 CA4th 34, 47-49, 6 CR2d 602, 609-610—3% share interest deemed substantial when necessary to consummate sale of all of corporation's stock]

1) [6:401.3] **Effect:** Because of the "substantial interest" limitation, corporations may not avoid the anti-competition prohibition by forcing employees to enter into sham stock purchase and buy-back agreements. [*Bosley Med. Group v. Abramson* (1984) 161 CA3d 284, 290, 207 CR 477, 481—covenant not to compete void where employee forced to purchase noncontrolling interest in corporation and resell it upon termination of employment]

(b) [6:401.4] **Nonsolicitation agreements:** Employment agreements will often include nonsolicitation covenants prohibiting employees from soliciting the employer's customers and employees for a certain period of time after termination of employment. Such provisions are generally unenforceable in view of California's strong public policy promoting competition. [See *Edwards v. Arthur Andersen LLP* (2008) 44 C4th 937, 948, 81 CR3d 282, 290 (solicitation of customers); *AMN Healthcare, Inc. v. Aya Healthcare Services, Inc.* (2018) 28 CA5th 923, 935-939, 239 CR3d 577, 587-590 (solicitation of employees)]

While employers may include covenants in employment agreements protecting confidential information and trade secrets, those covenants will not be enforced when relied upon to restrain competition rather than to enforce legitimate interests in protecting trade secrets. [See *Whyte v. Schlage Lock Co.* (2002) 101 CA4th 1443, 1461, 125 CR2d 277, 292-293—"inevitable disclosure doctrine" (former employee who signed nondisclosure agreement may be enjoined from working for competitor upon showing new job duties will necessarily result in disclosure of trade secrets) rejected as contrary to California law]

Cross-refer: For further discussion of nondisclosure and similar agreements with employees, see Chin, Wiseman, Callahan & Lowe, *Cal. Prac. Guide: Employment Litigation* (TRG), Ch. 14.

(c) [6:401.5] **Current employees:** Bus. & Prof.C. § 16600 does not apply to an employee's promise not to compete with an employer while employed. The statute's public policy "is not to immunize employees who undermine their employer by competing with it while still employed." [*Techno Lite, Inc. v. Emcod, LLC* (2020) 44 CA5th 462, 471, 473, 257 CR3d 643, 649-650, 652; see also *Fowler v. Varian Assocs., Inc.* (1987) 196 CA3d 34, 41, 241 CR 539, 543—"During the term of employment, an employer is entitled to its employees' undivided loyalty"]

[6:401.6 - 6:401.7] ***Reserved.***

(3) Out-of-state contracts involving California businesses and/or workers

(a) [6:401.8] **Noncompetition covenant not binding on California hirers:** Out-of-state employers cannot prevent their non-California employees from working for a California employer based on an employment contract barring terminated employees from working for competitors. This is so even where the contract designates the out-of-state law as governing the contract and even though the noncompetition covenant is valid under that law. [Bus. & Prof.C. § 16600.5 (added Stats. 2023, Ch. 157; eff. 1/1/24); see Bus. & Prof.C. § 16600.5(b)—no employer or former employer may attempt to enforce void noncompete even if contract signed and employment maintained outside California; *Application Group, Inc. v. Hunter Group, Inc.* (1998) 61 CA4th 881, 901-902, 72 CR2d 73, 85-86—in addition to benefiting employees, Bus. & Prof.C. § 16600 reflects California's "strong and legitimate interest" in allowing its *employers* "to compete effectively for the most talented, skilled employees in their industries, *wherever they may reside*" (emphasis added)]

1) [6:401.8a] **Comment:** The Ninth Circuit once held that California public policy was not offended where a California employee and an out-of-state employer entered into a stock option agreement, governed by the out-of-state law, providing for cancellation of the option if the employee worked for a competitor within six months after exercising the option (*International Business Machines Corp. v. Bajorek* (9th Cir. 1999) 191 F3d 1033, 1040-1041).

But the California Supreme Court has since *expressly rejected* the *Bajorek* holding (see *Edwards v. Arthur Andersen LLP* (2008) 44 C4th 937, 949, 81 CR3d 282, 291-292), leaving the Ninth Circuit decision with *no precedential value* on this state law issue. [See *Johnson v. Fankell* (1997) 420 US 911, 916, 117 S.Ct. 1800, 1803-1084—"Neither this Court nor any other federal tribunal has any authority to place a construction on a state statute different from the one rendered by the highest court of the State"; *Muniz v. United Parcel Service, Inc.* (9th Cir. 2013) 738 F3d 214, 219—California Supreme Court decisions "are binding on us as to California law"; and Goelz, Batalden & Querio, *Rutter Group Prac. Guide: Federal Ninth Circuit Civil Appellate Practice* (TRG), Ch. 8]

[6:401.9] ***Reserved.***

(b) [6:401.10] **Compare—limited noncompetition clause in contract requiring arbitration of disputes:** California public policy was not violated where a California sales consultant and an out-of-state company entered into an agreement containing a limited noncompetition clause, an arbitration provision and a clause stipulating the contract was governed by the out-of-state law. The arbitrator could rightfully determine that the other state's law governed, the noncompetition clause was valid and the consultant violated the clause. Moreover, the noncompetition clause, which prohibited the consultant from selling competing products for two years following his termination and from disclosing the company's trade secrets (including customer names and addresses), was not palpably contrary to California law (*see ¶ 6:401.4*). [*Jones v. Humanscale Corp.* (2005) 130 CA4th 401, 407-413, 29 CR3d 881, 886-891; see also *Singerlewak LLP v. Gantman* (2015) 241 CA4th 610, 621-625, 193 CR3d 672, 679-683—no judicial review permitted of arbitration award in dispute between partnership and retired partner over reduction in liquidation payments payable by reason of partner's services to former clients in violation of partnership agreement's noncompetition covenant]

(*Comment:* The *Jones* and *Singerlewak* decisions are properly interpreted as heavily influenced by California public policy supporting the use of private arbitration to resolve disputes and the concomitant need for arbitral finality. Had *Jones* and *Singerlewak* been litigated in court, rather than in arbitration, the results may very well have been different, with the noncompetition clauses invalidated. See *NuVasive, Inc. v. Miles* (Del. Ch. 2019) 2019 WL 4010814 (unpub.), *discussed at ¶ 6:401.1*.)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[6:401.11 - 6:401.14] ***Reserved.***

(4) [6:401.15] **Compare—federal law banning noncompete clauses:** Effective September 4, 2024, a Federal Trade Commission (FTC) rule bans *virtually all* existing and future employment-related noncompete clauses nationwide, with a few *narrow* exceptions (¶ 6:401.19). Under the rule, it is an "unfair method of competition" to enter into or attempt to enter into, enforce or attempt to enforce, or represent that a "worker" (¶ 6:401.16) is subject to a noncompete clause. [16 CFR Part 910 (added eff. 9/4/24); see 16 CFR §§ 910.2(a)(1), 910.6; see also 15 USC §§ 45(a)(1), 46(g); FTC comments at 89 FR 38342-01 (May 7, 2024); and, for a discussion of noncompete clauses under *California law, see*¶ 6:401.1 ff.]

Caution: As of the date this publication went to press, several lawsuits had been filed in federal courts challenging the FTC's constitutional and statutory authority to promulgate 16 CFR Part 910 (see *Ryan, LLC v. Federal Trade Commission*, Case No. 3:24-cv-00986 (ND Tex.); *Chamber of Commerce of the United States of America v. Federal Trade Commission*, No. 6:24-cv-00148 (ED Tex.); *ATS Tree Services, LLC v. Federal Trade Commission*, No. 2:24-cv-01743 (ED Pa.)). These challenges could impact the September 4, 2024 effective date.

(a) [6:401.16] **"Worker":** "Worker" is broadly defined as a natural person, whether paid or unpaid (and regardless of their title or status under any other state or federal laws), including, but not limited to, an employee, independent contractor, extern, intern, volunteer, apprentice, or "sole proprietor who provides a service to a person." The term also includes a person who works for a franchisee or franchisor, but *not* a franchisee in the context of a franchisee-franchisor relationship. [16 CFR § 910.1]

(b) [6:401.17] **Application to "senior executives":** An *existing* noncompete clause entered into with a "senior executive" (i.e., a worker in a "policy-making position," as defined, who earns more than $151,164) can remain in force. However, senior executive noncompete agreements entered into *after September 4, 2024 are unenforceable*. [16 CFR §§ 910.1, 910.2(a)(2)]

(c) [6:401.18] **"Noncompete clause":** A "noncompete clause" is an employment term or condition (whether written or oral, and including, but not limited to, a contractual term or workplace policy) that "*prohibits* a worker from, *penalizes* a worker for, or *functions to prevent* a worker from" seeking or accepting work in the U.S. with a different person, or operating a business in the U.S., after the subject employment has ended. [16 CFR § 910.1 (emphasis added)]

(d) [6:401.19] **Exceptions:** The rule does not apply (i) to a noncompete clause entered into pursuant to a "bona fide sale" of a business entity, a person's ownership interest in a business entity, or all or substantially all of a business entity's operating assets, (ii) where a cause of action related to a noncompete clause *accrued before September 4, 2024*, or (iii) where the person enforcing or attempting to enforce the noncompete clause has a "good-faith basis" to believe the rule is inapplicable. [16 CFR § 910.3]

(e) [6:401.20] **Notice requirements:** Employers must give workers who have noncompete clauses "clear and conspicuous" notice that the clauses are no longer enforceable. The notice must identify the person with whom the worker entered into the noncompete clause, be "on paper," and be delivered by hand, mail, email, or text. The rule specifies model language satisfying the notice requirement. [See 16 CFR § 910.2(b); for a discussion of *California law* notice requirements, *see*¶ 6:401.1b]

(f) [6:401.21] **State law preempted:** 16 CFR Part 910 supersedes conflicting state laws. However, this does not impact the state attorney general's or any other regulatory or enforcement agency's authority, or the rights of a person, to bring a state claim or regulatory action, including state antitrust and consumer protection laws and state common law. [16 CFR § 910.4]

(g) [6:401.22] **Severability:** If any provision of 16 CFR Part 910 is held invalid or unenforceable by its terms or as applied, the provision or application is severable and does not affect the remainder. [16 CFR § 910.5]

d. [6:402] **Compensation:** Various issues may arise in connection with executive compensation arrangements:

(1) Nature of services rendered

(a) [6:403] **Directors:** A director is not entitled to compensation for serving *as a director*, unless a fee for such service is provided in the articles, bylaws or by board resolution adopted *before* the services were rendered. Retroactive compensation or bonuses to directors are improper. [See *Bassett v. Fairchild* (1901) 132 C 637, 643-644, 64 P 1082, 1084; *Wickersham v. Crittenden* (1892) 93 C 17, 32, 28 P 788, 791 ("A director in a corporation is not entitled to compensation

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

for his services as director, in the absence of any agreement in advance that he shall receive such compensation”); *Briskin v. Oceanside Marina Towers Ass'n* (Cal.App. 2015) 2015 WL 1307204, *3 (unpub.)—“Generally, a corporate director is not entitled to compensation for ordinary services absent an advance agreement”]

The rationale is that directors are fiduciaries and are *presumed to be serving gratuitously*. Therefore, they may not charge for their services unless it was expressly agreed in advance that a charge would be made. [*Bassett v. Fairchild*, supra]

1) [6:404] **Compare—“extraordinary” services:** But where a director has performed “extraordinary” services for the corporation (e.g., serving as counsel to the corporation in litigation), an agreement by the corporation to compensate the director is *implied*. In such event, the director is entitled to “reasonable” compensation for the services even in the absence of express prior authorization. [*Bassett v. Fairchild* (1901) 132 C 637, 643-644, 64 P 1082, 1084]

Services are deemed “extraordinary” if of a type “for which compensation is usually demanded and allowed, and which *could not reasonably be expected to be performed for nothing*.” [*Bassett v. Fairchild*, supra, 132 C at 643, 64 P at 1084 (emphasis added)]

2) [6:404.1] **Comment:** Current practice is to pay reasonable fees to nonemployee directors serving as directors. This is certainly so for public corporations, as well as for private corporations that are substantial or that have more than a few shareholders.

Director compensation is subject to the GCL's interested-director provisions and therefore must either be approved by the shareholders or qualify as “just and reasonable” to the corporation at the time the compensation is authorized (*see ¶ 6:285 ff.*). Larger corporations often retain compensation consultants to assist in determining appropriate compensation.

(b) [6:405] **Officers:** On the other hand, corporate officers are usually entitled to compensation for services rendered, even in the absence of express prior agreement. They are entitled to recover in quasi-contract for the reasonable value of the services they perform on the corporation's behalf. [See *Bassett v. Fairchild* (1901) 132 C 637, 643, 64 P 1082, 1084; and *Security-First Nat'l Bank of Los Angeles v. Lutz* (9th Cir. 1963) 322 F2d 348, 354]

Moreover, the fact that an officer is also a director of the corporation does not affect their right to compensation for services performed as an officer or employee (subject to conflict-of-interest limitations discussed at *¶ 6:285*).

(2) [6:406] **Types of compensation, generally:** Patterns of executive compensation vary widely. The form and amount usually depend on the nature of the job, the skill and experience required, the size of the company, and the relationship of the employee to the corporation. But they usually include several or all of the following components:

• Base salary;

• Incentive arrangements (including bonuses, stock options, stock grants, stock appreciation rights, restricted stock issuances, etc.; *see ¶ 6:406.1*);

• Deferred compensation;

• Qualified pension and profit-sharing plans;

• Death benefits, group term insurance, and other employee benefit plans.

(3) [6:406.1] **Employee stock option or purchase plans as compensation:** Stock purchase or option plans or agreements are expressly authorized by the Code. They may provide for issuance of the corporation's stock to employees (including officers) or to directors of the corporation (or to any parent or subsidiary). [Corps.C. § 408(a)]

(a) [6:406.2] **Typical features:** Such plans may contain a variety of features, including:

• Issuing restricted stock to officers that vests over a period of time conditioned upon continued employment;

• Granting options to purchase shares at the current market price;

• Permitting payment for the shares through payroll deductions;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Loaning corporate funds for the purchase, whether liability therefor is limited to the security for the loan (i.e., a secured "non-recourse" loan), or the borrower is personally liable for the debt (a "recourse" loan, that may be secured or unsecured);

• Permitting payment by promissory note, whether recourse (secured or unsecured) or nonrecourse and secured; and

• Permitting the shares to be paid for in installments. [Corps.C. § 408(a), (b); see *Schachter v. Citigroup, Inc.* (2009) 47 C4th 610, 621-622, 101 CR3d 2, 12—employee stock purchase plan providing for forfeiture of shares acquired within 2 years prior to voluntary termination of employment or termination for cause did not violate Lab.C. §§ 201, 202 and 219 requiring payment of all earned but unpaid wages upon termination; *and*¶ *2:219 ff.*]

(b) [6:406.3] **Shareholder approval:** While board approval of equity incentive plans may be sufficient without the necessity of obtaining shareholder approval, plans that provide grants to *directors* are typically submitted for shareholder approval to obtain the protections for shareholder-approved compensation accorded to interested director transactions under Corps.C. § 310. [Corps.C. § 310(a)(1), ¶ 6:285 ff.; see *Calma v. Templeton* (Del.Ch. 2015) 114 A3d 563, 578-587 (discussing history of rationale for shareholder approval of director compensation)]

Moreover, shareholder approval may be required to obtain favorable tax treatment (e.g., to qualify as an incentive stock option plan, *see*¶ *2:223*; or to qualify as an employee stock purchase plan, *see*¶ *2:223.1*).

Shareholder approval is also required for most equity compensation plans (e.g., stock option, stock purchase and similar plans) adopted by companies listed on the New York Stock Exchange or Nasdaq. [See NYSE Listed Company Manual § 303A.08; Nasdaq Rule 5635(c)]

(c) [6:406.4] **Loan approval by board alone:** Moreover, it appears that the board alone can authorize employee (or even director) share-purchase loans pursuant to a plan adopted under Corps.C. § 408, even if they are nonrecourse. Such loans are exempt from the general prohibition against officer or director loans without shareholder approval. [Corps.C. § 315(f)(1); *see* ¶ *6:475*]

• [6:406.5] **Caution:** These loans would generally constitute "interested-director transactions" and be subject to conflict-of-interest limitations and the requirements of Corps.C. § 310 (*see*¶ *6:285 ff.*).

Moreover, SEA reporting companies and their subsidiaries are prohibited from making personal loans to any of their directors or executive officers, including loans to enable the purchase of company shares. [SEA § 13(k)(1) (15 USC § 78m(k)(1))]

(d) [6:406.6] **ERISA plans—trustee's standard of prudence:** An employee stock purchase plan may be cast in the form of a pension or retirement plan. If so, it is subject to ERISA as an employee stock ownership plan (ESOP), and the ESOP trustee (administrator) is obligated to exercise the same standard of prudence applicable to all ERISA fiduciaries (per 29 USC § 1104(a)(1)(B), *see* ¶ *6:256.5*). [*Fifth Third Bancorp v. Dudenhoeffer* (2014) 573 US 409, 416-425, 134 S.Ct. 2459, 2465-2471—ESOP fiduciary not entitled to presumption that it acted prudently; *see also* ¶ *6:438.2* re indemnification of ERISA fiduciaries]

1) [6:406.7] **Special concerns where trustee possesses "inside information":** The ESOP trustee is often the corporation or one or more of its officers, directors, executive employees or other "insiders." Such an insider's ostensible duties as an ESOP trustee may conflict with its obligations under the securities laws not to trade on material inside (nonpublic) information. (E.g., ESOP trustee with inside information that corporation is faltering may have duty as fiduciary to sell ESOP's stock but may be precluded from doing so under SEC Rule 10b-5, ¶ 6:358 ff.) In such circumstances, the ERISA duty of prudence does *not* require an ESOP fiduciary to break the law—i.e., the ESOP trustee need *not* use its inside information to sell the ESOP's stock in violation of securities laws. [*Fifth Third Bancorp v. Dudenhoeffer* (2014) 573 US 409, 428-429, 134 S.Ct. 2459, 2472; see *Retirement Plans Committee of IBM v. Jander* (2020) 589 US 49, 50, 140 S.Ct. 592, 594 (per curiam)]

Where ESOP fiduciaries are faulted for failing to decide, on the basis of inside information, whether to *halt stock purchases* or *publicly disclose the inside information so that the stock would no longer be overvalued*, courts must consider whether such decisions could conflict with the federal securities laws. Additionally, courts must consider whether a halt in stock purchases (which the market might take as a sign that insider fiduciaries view the employer's stock as a bad investment) or public disclosure of negative information would do the ESOP *more harm than good*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

by causing a drop in value of the ESOP's stock. [*Fifth Third Bancorp v. Dudenhoeffer*, supra, 573 US at 428-429, 134 S.Ct. at 2473; see *Retirement Plans Committee of IBM v. Jander*, supra; *Amgen Inc. v. Harris* (2016) 577 US 308, 311, 136 S.Ct. 758, 759-760 (per curiam)]

2) [6:406.8] **Plan participants' standing to sue for mismanagement:** Participants in an ERISA defined-benefit plan do not have standing to sue for mismanagement of the plan if the participants received all the benefits they were owed under the plan and are legally and contractually entitled to continue receiving their benefits. [*Thole v. U.S. Bank N.A.* (2020) 590 US 538, 540-541, 140 S.Ct. 1615, 1618-1619]

(4) [6:407] **Tax considerations:** The tax effects, both to the corporation and to the individuals involved, are usually the key considerations in determining the form and amount of executive compensation.

A corporate employer will usually want to be assured of immediate tax deductions for every dollar paid to or for the benefit of the employee. On the other hand, an employee will usually prefer a plan that defers some portion of the taxes to a later date or that converts ordinary income into capital gain.

To balance these competing considerations, a combination of several forms of compensation is often utilized.

(a) [6:408] **Immediate deductions and no taxable income:** The most tax-favored type of compensation allows immediate deductions to the corporate employer, without any taxable income to the employee.

This is available for:

- Nondiscriminatory employees' group term life insurance up to $50,000 per person; [IRC § 79, *see*¶ *2:215*]
- Employees' health/accident insurance plans and nondiscriminatory medical expense reimbursement plans; [IRC §§ 105, 106, *see*¶ *2:216*]
- And, other "employee benefit" plans. [See, e.g., IRC §§ 104, 120, 129 and 501(c)(9)]

[6:409] ***Reserved.***

(b) [6:410] **Immediate deductions and deferred income:** The "next best" from a tax standpoint are qualified *retirement plans*. Amounts paid in by the corporate employer on behalf of their employees can be deducted immediately, but the covered employees pay no tax until the funds invested, plus the earnings thereon, are disbursed (e.g., until retirement or termination of the plan).

Included in this category are:

- Qualified *profit-sharing plans*, under which the corporate employer may vary the amount of the annual contributions, which are not dependent on whether it has current or accumulated earnings and profits. [IRC § 401(a)(27)]
- Qualified *money purchase pension plans*, under which the employer is obligated to make a fixed annual contribution, regardless of earnings. [Treas.Reg. § 1.401-1(b)(1)]
- Qualified *cash or deferred arrangement plans* ("401(k) plans") under which employees may make annual elective deferrals of salary up to $23,000 ($30,500 for employees age 50 or over). [IRC §§ 401(k), 402(g); IRS Notice 2023-75, 2023-47 IRB 1256]
- Qualified *defined benefit pension plans*, under which the employer commits to provide a definitely determinable benefit to participants at retirement, and must fund such amounts (within limits) as are necessary from time to time to meet the commitments. [Treas.Reg. § 1.401-1(b)(1)]

[6:411] ***Reserved.***

(c) [6:412] **Immediate deduction and immediate income:** Most salaries, commissions, and bonuses (cash or stock) fall in this category.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Such payments are less advantageous to the employee because every dollar received is taxed (and subject to withholding). And, if the distribution is a noncash item (e.g., shares of stock), the employee will have to come up with the cash to pay the taxes.

Such distributions are also less advantageous to the employer—because, although fully deductible, payments of this type will increase the employer's employment taxes (social security, unemployment insurance, etc.) and retirement fund contributions.

(d) [6:413] **Deferred deduction and deferred income:** This category includes *stock grants* that are expressly nontransferable or subject to a “substantial risk of forfeiture” (e.g., conditioned upon future employment). Tax recognition for the executive and a deduction for the corporation are both deferred until the executive's rights become either transferable or no longer subject to forfeiture. (Also, an employee of an “eligible corporation” may further defer the recognition of gain by making an election no later than 30 days after the date the employee's right to the stock is substantially vested or becomes transferable, whichever occurs first.) [IRC § 83; *see*¶ *2:174 ff.*]

Salary may be also deferred until a future date under certain “nonqualified” plans. Here again, however, there is no immediate deduction to the corporation and a risk of loss to the employee. [IRC § 404]

For example, employer “contributions” to a deferred compensation plan that is unfunded, unsecured and subject to risk of forfeiture are not taxable income to the employee (because not capable of current valuation). But the corporation may not currently deduct such contributions, and the employee's interest is unprotected against the employer's creditors. [See *Minor v. United States* (9th Cir. 1985) 772 F2d 1472, 1474-1475; and *Albertson's, Inc. v. Commr.* (9th Cir. 1994) 42 F3d 537, 544-545—employer may not currently deduct interest accrued on nonqualified deferred compensation]

(e) [6:414] **No deduction and deferred income:** Stock options fall in this category. There is generally no tax consequence when a nonqualified option is granted, but when it is exercised, the employee realizes *ordinary* income (the difference between the market price and option price). [*Pagel, Inc. v. Commr.* (8th Cir. 1990) 905 F2d 1190, 1191] And, the employer is then entitled to a corresponding deduction (if the withholding requirements are met).

Even better treatment is available for “incentive stock options” (*see*¶ *2:219*) or “employee stock purchase plans” (*see*¶ *2:223.1*). No income is realized when the option is granted or exercised. Rather, it is deferred until the optioned shares are *sold*, and then taxable only as a *capital gain*. But the employer gets no deduction. [IRC § 422; *see*¶ *2:220*]

1) [6:414a] **Comment:** Given the significant disparity between ordinary income rates at the higher brackets (24% to 37%, *see* ¶ *2:99*) and the maximum rate on capital gains (23.8%, *see*¶ *2:100.1*), highly compensated personnel may pressure the corporation to adopt compensation plans that convert ordinary income into capital gain … notwithstanding the tax disadvantages to the corporation.

(5) [6:414.1] **Securities law requirements:** The *right* or *option* to purchase a corporation's stock is a “security” (*see*¶ *5:32*). Accordingly, federal and state securities laws must be complied with when the company's stock, or a right or option to acquire stock, is offered as compensation.

(a) Compliance with federal securities laws

1) [6:414.2] **Employee stock options:** The *grant* of an employee stock option is not considered an “offer to sell” a security “for value” under the 1933 Act. Thus, registration is not required. Reason: Although the employee's services typically constitute consideration for the option grant, the prevailing view is that acceptance of the grant is an *employment*—not an “investment”—decision. [See Overman, “Registration and Exemption from Registration of Employee Compensation Plans Under the Federal Securities Law,” 28 Vand.L.Rev. 455, 460-461 (1974); and *Dayton Steel Foundry Co.* (1971) Fed.Sec.L.Rep. (CCH) ¶ 78,443]

But, the *exercise* of an outstanding stock option *does* involve a “sale” of the security. Registration will be required unless an exemption applies (¶ 6:414.4). (Form S-8 should be used for 1934 Act reporting companies; Form S-1 for all other companies.)

2) [6:414.3] **Employee stock purchase plans:** Employee stock purchase plans generally involve an “offer to sell” the company's securities. Thus, registration is required unless an exemption is available (¶ 6:414.4).

3) [6:414.4] **Exemptions from registration:** SEC Rule 701 (¶ *5:189.1*) expressly exempts offers and sales of securities issued by a *nonreporting* company pursuant to employee benefit or compensation plans or agreements. The

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

maximum amount that may be *sold annually* is the *greatest* of (i) $1 million, (ii) 15% of the issuer's total assets, or (iii) 15% of the outstanding securities of that class. (Securities sold under Rule 701 are "restricted securities" and cannot be resold absent registration or an exemption from registration.) [SEC Rule 701 (17 CFR § 230.701)]

Additionally, employee stock option or stock purchase plans may be exempt from registration under the *intrastate* exemption (SA § 11, Rules 147 and 147A; *see* ¶ *5:81 ff.*) or the exemptions for *nonpublic offerings* under Regulation D and SA § 4(a)(2) (*see* ¶ *5:107 ff.*). [See SA §§ 4(a)(2), 11 (15 USC §§ 77d(a)(2), 77k); SEC Rule 147 (17 CFR § 230.147); SEC Rule 147A (17 CFR § 230.147A)]

4) [6:414.4a] **Executive compensation "clawback" for financial statement irregularities ("listed" companies):** Companies with securities listed on a national securities exchange must implement a policy to recover incentive-based compensation that was paid based on inaccurate financial statements that do not comply with accounting standards. Compensation, including stock options, in excess of what would have been paid if correct accounting procedures had been followed can be recovered from a current or former executive officer under a three-year look-back period beginning on the date a company has to prepare an accounting restatement based on the erroneous data. [SEA § 10D (15 USC § 78j-4)]

(b) [6:414.5] **Compliance with California securities laws:** Where no exemption is available (*see* ¶ *6:414.6*), a corporation's grant of a stock option must be qualified. Under established practice, qualification is obtained for both the issuance (grant) of the option and the future issuance of the underlying shares upon exercise of the option. (*See*¶ *5:334 ff.* for qualification standards.)

1) Exemptions from qualification

a) [6:414.6] **Rule 701 exempt securities:** The offer or sale of a security issued pursuant to a stock option or stock purchase plan or agreement is exempt from the California qualification requirements if the transaction is exempt from federal registration under SEC Rule 701 (¶ *6:414.4*) and if certain other requirements are met. [Corps.C. § 25102(o); *see*¶ *5:305 ff.*]

b) [6:414.7] **"Limited offering" exemption:** The "limited offering" exemption (Corps.C. § 25102(f), ¶ *5:256 ff.*) is available for stock options and stock purchase rights, but it is limited to no more than 35 "counted" employees having the requisite personal qualifications (*see*¶ *5:261*).

c) [6:414.8] **Exemption for reporting company incentive stock options:** Also, the Financial Protection and Innovation Commissioner has specifically exempted from qualification certain *incentive stock options* (¶ *2:219 ff.*) issued by a 1934 Act reporting corporation. [See Commr. Rule 260.105.8]

(6) [6:415] **"Reasonableness" as limitation:** The amount and form of compensation paid to a corporate employee are subject to the requirement of "reasonableness." Two separate concepts are involved:

(a) [6:416] **As limit on deductibility:** For tax purposes, a deduction is allowed only for "a reasonable allowance for salaries or other compensation for personal services actually rendered." [IRC § 162(a)(1); *see*¶ *2:106*]

1) [6:417] **Test:** "Reasonableness" for tax deduction purposes is a question of *fact* to be determined on the basis of all the facts and circumstances. The relevant factors are:

- The employee's role in the corporation, including hours worked and duties performed;
- A comparison of the employee's salary with salaries paid by similar companies for similar services;
- The corporation's character and condition, focusing on its size, complexity, net income and general economic condition;
- Potential conflicts of interest by which the corporation may be disguising nondeductible dividends as salary;
- Internal consistency (i.e., whether the compensation was awarded under a structured, formal, consistently-applied program); and
- Whether an independent investor would be willing to compensate the employee as the corporation compensated the employee. [*Metro Leasing & Develop. Corp. v. Commr.* (9th Cir. 2004) 376 F3d 1015, 1019; *Elliotts, Inc. v.*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Commr. (9th Cir. 1983) 716 F2d 1241, 1245-1247; *H.W. Johnson, Inc. v. Commr.*, TC Memo 2016-95; see *Aries Communications Inc. & Subs. v. Commr.*, TC Memo 2013-97—compensation paid to sole shareholder as "catch-up" payments for prior years and made after sale of corporation's assets was not reasonable even though shareholder may have been underpaid prior to sale]

2) [6:418] **Excessive salaries as constructive dividends:** Amounts paid in excess of "reasonable" compensation to employee-shareholders may be attacked as "constructive dividends." The corporation loses the deduction for such excess, so that the profits represented thereby are *taxed twice* (once at the corporate level and again as income to the employee-shareholder). [See *Metro Leasing & Develop. Corp. v. Commr.* (9th Cir. 2004) 376 F3d 1015, 1017-1019; *Eberl's Claim Service, Inc. v. Commr.* (10th Cir. 2001) 249 F3d 994, 998-1002; *Transupport, Inc. v. Commr.*, TC Memo 2016-216; *and ¶ 2:105 ff.*]

3) [6:419] **Effect of "repay" agreements:** To avoid this disastrous tax result, employment agreements in small, closely held corporations may provide that the employee will *repay* to the corporation any portion of their compensation disallowed as a deduction by the federal or state taxing authorities.

Where such agreements are in effect prior to the disallowance of the salary deduction, amounts paid by the employee are deductible (in the year of repayment) as a "trade or business" expense … thus avoiding the double tax. [IRC § 162; *Charles Schneider & Co., Inc. v. Commr.* (8th Cir. 1974) 500 F2d 148, 150]

a) [6:420] **Caution—"red flag" to IRS:** However, including such a provision in the employment agreement is dangerous: It may operate as a "red flag" to the IRS in the event of an audit; it may be treated as an *admission* by the parties that the salary is excessive, and that they expect it to be disallowed. [*Oswald v. Commr.* (1968) 49 TC 645]

[6:420.1 - 6:420.4] ***Reserved.***

4) [6:420.5] **No deduction for public corporation executive pay over $1 million:** The *maximum* deduction allowed to a "public" (i.e., SEA "reporting") corporation, or a corporation subject to SEA § 15(d) (*see ¶ 5:56.6*), for compensation paid to "covered employees" (¶ 6:420.6 ff.) is *$1 million* per each such employee. [IRC § 162(m); see Treas.Reg. § 1.162-33]

a) [6:420.6] **Maximum deduction applies to 5 covered employees until 2027:** For taxable years that begin before January 1, 2027, the $1 million maximum deduction (¶ 6:420.5) applies to five separate covered employees: (i) the principal executive officer, (ii) the principal financial officer, and (iii) the three highest-paid officers *other than* the principal executive officer and the principal financial officer. [IRC § 162(m)(3)]

b) [6:420.7] **Maximum deduction will apply to 10 covered employees beginning in 2027:** For taxable years beginning on or after January 1, 2027, the $1 million maximum deduction (¶ 6:420.5) will apply to the eight highest-paid officers plus the principal executive officer and the principal financial officer. [IRC § 162(m)(3); Treas. Reg. § 1.162-33(c)(2)]

(b) [6:421] **As "waste" of corporate assets:** "Unreasonable" salaries or other compensation paid to management may also be challenged as a waste of corporate assets. Even when approved by a "disinterested" board, "unreasonably" large payments to officers and directors may constitute a "waste" of corporate assets, and thus violate the directors' fiduciary duties to the corporation (*see¶ 6:244*). (This claim could be raised in a derivative suit filed by a dissident shareholder against the directors authorizing such payments and the officers receiving same; *see¶ 6:602 ff.*)

1) [6:422] **Test:** "Reasonableness" for fiduciary duty purposes does not focus as heavily on what other businesses are paying for similar services. Rather, it is sufficient if the services are related to the corporation's business, and the amount paid bears some relationship to the value of such services—even if the services did not result in any actual benefit to the corporation. [See *Rogers v. Hill* (1933) 289 US 582, 589, 53 S.Ct. 731, 734]

2) Application

a) [6:423] **Services previously rendered:** Bonuses or retroactive pay increases for past services will usually be upheld. Reason: Even if the corporation was under no legal obligation to make such payments, they can be justified as additional incentive or consideration for *future* services by the officer or employee.

b) [6:424] **Departure bonuses:** On the other hand, "departure bonuses" and other severance payments to an officer or director upon leaving the corporation (e.g., retirement) may be subject to attack. If there was no obligation to

make the payment, it may be treated as a "gift" of corporate assets, and a breach of the directors' fiduciary duties to the corporation. [See 70 ALR 1432; *In re Walt Disney Co. Derivative Litig.* (Del. 2006) 906 A2d 27, 73-75—$130 million contractual severance package paid to president terminated without cause after only 14 months in office did not constitute waste or breach of fiduciary duty]

➪ [6:425] ***PRACTICE POINTER:*** One possible way to avoid this problem is to make the payment to the departing officer or director in exchange for their promise to "consult" or "advise" in the *future*. This is a legally-sufficient consideration to render the corporation's promise enforceable; i.e., not a gift.

But the issue of "waste" of corporate assets could still be raised if it appears that no future services or competition by the departing officers was really contemplated.

c) [6:425.1] **"Golden parachutes":** "Waste" might also be raised as an issue with respect to "golden parachute" provisions in executive employment contracts: i.e., provisions requiring the corporation to make large, additional salary or bonus payments in the event of *change in ownership or control* of the corporation. (Typically, such provisions are used to deter hostile takeovers of public companies which might result in insiders losing their jobs.) [See, e.g., *International Ins. Co. v. Johns* (11th Cir. 1989) 874 F2d 1447, 1460; *Gaillard v. Natomas Co.* (1989) 208 CA3d 1250, 1265, 256 CR 702, 711 (disapproved on other grounds by *Grosset v. Wenaas* (2008) 42 C4th 1100, 1119, 72 CR3d 129, 144, fn. 16); also see *Cline v. Commr.* (7th Cir. 1994) 34 F3d 480, 481-482; *Square D Co. v. Commr.* (2003) 121 TC No. 11; *and*¶ *6:247.11*]

1/ [6:425.2] **Tax limitations:** For all practical purposes, "golden parachute" payments (¶ 6:425.1) to "disqualified individuals" (¶ 6:425.2a) cannot exceed three times the individual's average annual compensation during the previous five years. Any amounts paid in excess thereof are *not deductible by the corporation* as a business expense; and are subject to a *20% excise tax* on top of regular income tax … so that an executive in the 37% bracket could end up paying 57% tax on the excess. [IRC §§ 280G, 4999; Treas.Reg. § 1.280G-1]

The only way to avoid this result is if the executive remains with the corporation and proves that their services were really worth the additional payments: e.g., by showing that they constitute an accelerated payment, due to the ownership change, of previously earned compensation (such as payments for cancellation of stock option rights granted more than one year before such change). [IRC §§ 280G, 4999; see Treas.Reg. § 1.280G-1]

2/ [6:425.2a] **"Disqualified individuals" defined:** The tax limitations on "golden parachute" payments (¶ 6:425.2a) apply to any individual who is, during the determination period (the 12-month period prior to and ending on the date the corporation's ownership or control changes), (i) an employee or independent contractor, and also (ii) a shareholder, officer, or highly-compensated individual. [IRC § 280G(c); Treas.Reg. § 1.280G-1 (Q/A 15)]

To be a "shareholder" for purposes of the "golden parachute" limitations, an individual must own more than one percent of the fair market value of the outstanding shares of all classes of the corporation's stock. [Treas.Reg. § 1.280G-1 (Q/A 17)]

A "highly-compensated individual" is an individual who is (or would be if they were an employee) among the corporation's highest paid one percent of employees or highest paid 250 employees, whichever is less. [IRC § 280G(c); Treas.Reg. § 1.280G-1 (Q/A 19)]

3/ [6:425.3] **Exceptions for small companies:** The limitations on "golden parachute" payments do not apply to a corporation that qualifies for S corporation status (*see*¶ *2:142 ff.*) or that would qualify for S corporation status but for the prohibition against nonresident alien shareholders (¶ *2:144*) (i.e., a corporation having a nonresident alien shareholder but otherwise meeting the S corporation requirements is not subject to the "golden parachute" limitations). [IRC § 280G(b)(5)(A)(i)]

Nor do the restrictions apply to parachute payments by a corporation whose stock is not readily traded on an established market, if the payments are approved by holders of more than 75% of its voting stock upon adequate disclosure of all facts concerning the payments. [IRC § 280G(b)(5)(A)(ii) & (B); see Treas.Reg. § 1.280G-1]

d) [6:426] **Uncertain future services:** Similar "waste" claims could be raised as to compensation paid for services to be rendered, if there is no certainty that the corporation will ultimately receive the benefit of the services for which it is paying. (For example, granting a lucrative stock option to an officer without conditioning it on his

remaining in the corporation's employ—so that the officer could quit the next day and still exercise the option fully in the future.) [See *Kerbs v. California Eastern Airways* (Del. 1952) 90 A2d 652, 656]

While each case turns on its own facts, courts are usually inclined to uphold such compensation, as long as adopted by a disinterested board, under the "business judgment" rule (¶ *6:245*).

(7) [6:427] **Conflict of interest as limitation:** Conflict-of-interest issues may arise whenever the board (or board committee) adopts a compensation plan benefitting one or more members of the board.

(a) [6:428] **Comment:** As a practical matter, conflict-of-interest problems re executive compensation rarely arise in closely-held corporations. This is because the shareholders normally serve as officers and directors and agree to each other's compensation. (If not, the corporation finds itself in deadlock and headed for dissolution.)

But such issues may arise if there are dissident minority shareholders receiving neither salaries nor dividends from the corporation. They may couple an attack on the "reasonableness" of the salaries paid to the officer-directors (¶ 6:415 ff.), with claims that the "mutual back-scratching" breached conflict-of-interest limitations (¶ *6:285*).

(b) [6:429] **"Interested" director may attend meeting:** The fact that a director has a personal interest in a matter being acted upon by the board does not affect their right to be counted as part of the quorum required for such meeting. [Corps.C. § 310(c); *see*¶ *6:213*]

Nor does such a director's presence or participation in the meeting render the board action void or voidable, if otherwise approved by a sufficient disinterested vote (¶ *6:296*). [Corps.C. § 310(a)]

(c) [6:430] **"Interested" director's vote not counted:** The "interested" director's vote cannot be counted in determining whether their compensation plan has been approved by a disinterested majority of the board (Corps.C. § 310(a)(2)). Nor are shares owned by such director entitled to vote in determining shareholder approval of such compensation plan. [Corps.C. § 310(a); *see*¶ *6:292 ff.*]

1) [6:431] **Compare—mutual "back scratching" permitted:** A mere common directorship does *not* constitute a "material financial interest." Directors therefore are not disqualified from voting on *each other's* compensation (i.e., as long as each abstains from voting on their own salary, "mutual back scratching" is permissible). [Corps.C. § 310(a), last sent.]

Distinguish: However, a director-*employee* may have a "material financial interest" in the compensation of an officer who has *hire/fire/promotion* authority over them. In such situations, the director's vote approving the compensation should *not* count as "disinterested."

(d) [6:432] **Effect of approval by shareholders or directors:** Executive compensation plans cannot be attacked on conflict-of-interest grounds if approved *either* by:

- A majority of disinterested shareholders (excluding an interested director's shares), acting in good faith, with full knowledge of all material facts; *or*

- The board of directors, or a committee of the board, acting in good faith, with full knowledge of all material facts, by a vote sufficient to approve without counting the interested director … provided the plan is also "*just and reasonable"* to the corporation at the time it is authorized, approved or ratified. [Corps.C. § 310(a)(1), (2); ¶ *6:292 ff.*]

1) [6:433] **"Reasonableness":** Note that "reasonableness" is *not* a requirement if the compensation plan is approved by a disinterested majority of the *shareholders*. It is only where the directors alone (and not the shareholders) have approved the plan that "reasonableness" must be shown. [See Corps.C. § 310(a)(1), (2), ¶ *6:296.3*]

2) [6:434] **Burden of proof re "reasonableness":** If the compensation plan was not approved *either* by a sufficient disinterested vote of the shareholders *or* by a sufficient disinterested vote of the directors, the burden is on "the person asserting the validity of the contract" (e.g., the "interested" director) to prove that the plan was "just and reasonable" to the corporation when adopted. [Corps.C. § 310(a)(3); ¶ *6:297*]

[6:435] But if the plan was approved by a sufficient disinterested vote of the directors, the person raising the conflict of interest claim (e.g., a dissident shareholder filing a derivative suit) bears the burden of proving *lack* of reasonableness. [See Corps.C. § 310(a)(3); ¶ *6:296.3*]

2. [6:436] **Indemnification of Officers and Directors:** Within the limits discussed below (¶ 6:437 ff.), a corporation may indemnify its officers or directors (or other employees or agents) against losses or expenses incurred in any "proceeding" arising out of their activities on behalf of the corporation. [Corps.C. § 317]

"Proceeding" is not limited to an actual judicial proceeding, but also encompasses *administrative* and *investigative* proceedings, as well as *threatened* proceedings. (Thus, e.g., officers or directors who incur attorney fees in connection with a threatened SEC or criminal investigation may be entitled to indemnification.) [Corps.C. § 317(a)]

[6:436.1] ***Caveat re SPCs:*** The paragraphs below (¶ 6:437 ff.) describe the statutory indemnification provisions applicable to corporations organized under the General Corporation Law (Corps.C. § 100 et seq.). SPCs (which are not organized under the General Corporation Law, *¶ 9:3*) are governed by statutory indemnification provisions that vary considerably from those contained in the General Corporation Law. *See discussion at¶ 9:43 ff., 9:121 ff.*

a. [6:437] **Statute as limit on indemnification:** The statutory indemnification provisions govern *unless* the corporation's articles expressly authorize indemnification in excess of the statutory limits discussed below. [Corps.C. §§ 204(a)(11), 317(g); *see¶ 6:464.1 ff.*]

(1) [6:437.1] **Compare—contractual indemnification:** Of course, persons (other than "agents," *see¶ 6:459.5*) may enforce their *contracts* with the corporation providing for indemnification. [Corps.C. § 317(g); see *Plate v. Sun-Diamond Growers of Calif.* (1990) 225 CA3d 1115, 1126, 275 CR 667, 673; also see *Branson v. Sun-Diamond Growers of Calif.* (1994) 24 CA4th 327, 338-339, 29 CR2d 314, 319—judicial determination that employee not entitled to statutory indemnification (*¶ 6:445 ff.*) did not preclude employee's subsequent suit seeking contractual indemnification]

(2) [6:438] **Compare—insurance coverage:** Corporations may properly purchase and maintain insurance protection for their directors and officers—*even for liabilities against which the corporation could not lawfully indemnify* ("D & O coverage," *see¶ 6:466*).

(3) [6:438.1] **Compare—indemnification for securities law violations:***See*¶ 5:71.5 (federal securities law); *and¶ 5:378* (state securities law).

(4) [6:438.2] **Compare—indemnification for ERISA liabilities:** Where corporate officers or directors also act as ERISA fiduciaries, contractual or state statutory indemnification provisions may be *preempted*—and hence *unenforceable*—to the extent they conflict with federal law. [29 USC §§ 1110(a), 1144(a); *Johnson v. Couturier* (9th Cir. 2009) 572 F3d 1067, 1078-1081—agreements providing complete indemnity so long as directors did not commit "deliberate wrongful acts" or "gross negligence" preempted by ERISA "prudent person standard" (29 USC § 1104(a)(1)(B), ¶ 6:256.5) to extent directors acted as trustees administering employee stock ownership plan (¶ 6:406.6*)*]

b. [6:439] **When indemnification *mandatory:*** If the director or officer accused of wrongdoing is *successful on the merits* in defense of the proceeding, indemnification is *mandatory*. The defendant "*shall* be indemnified against *expenses* actually and reasonably incurred" in defense of the proceeding (e.g., attorney fees, court costs, expert witness fees, etc.). [Corps.C. § 317(d) (emphasis added); *Groth Bros. Oldsmobile, Inc. v. Gallagher* (2002) 97 CA4th 60, 73, 118 CR2d 405, 414-415 (citing text)]

(Moreover, this indemnification right continues even after termination of the agent's relationship with the corporation, and inures to the benefit of their estate; Corps.C. § 317(g).)

(1) [6:440] **Purpose:** Giving officers and directors an absolute right to indemnification if they prevail encourages persons to serve as officers and directors of corporations (i.e., they are protected against the financial risk of defending against unfounded charges). It also *discourages* frivolous suits by dissident shareholders, since those sued will be motivated to defend vigorously. [See *Brusso v. Running Springs Country Club, Inc.* (1991) 228 CA3d 92, 103-104, 278 CR 758, 764 (citing text)]

(a) [6:440a] **Option to forgo corporate indemnification:** Corporate indemnification is "mandatory" *only* at the option of the *prevailing directors or officers*. They are free to seek reimbursement from some other source, such as the unsuccessful plaintiff who may be liable for litigation expenses pursuant to contract or statute. Unsuccessful plaintiffs *cannot* benefit from Corps.C. § 317(d) by forcing defendants to accept corporate indemnification. [*Brusso v. Running Springs Country Club, Inc.* (1991) 228 CA3d 92, 103-104, 278 CR 758, 764—where gravamen of derivative suit is breach of contract containing standard clause awarding litigation expenses to prevailing party (Civ.C. § 1717), prevailing defendants may seek expenses from individual plaintiffs]

(b) [6:440.1] **Includes corporate employees sued by corporation:** This right of indemnification extends to officers and directors who successfully defend against claims brought (directly or derivatively) by the corporation formerly employing them (e.g., for breach of fiduciary duties). [See Corps.C. § 317(d); *Wilshire-Doheny Assocs., Ltd. v. Shapiro* (2000) 83 CA4th 1380, 1390, 100 CR2d 478, 486]

[6:440.2 - 6:440.4] ***Reserved.***

(2) [6:440.5] **Defendant must have acted on behalf of corporation:** There can be no indemnification where the director's or officer's actions arose from the pursuit of purely *personal interests*: The actions must have occurred *in connection with the performance of corporate duties*. [*Wilshire-Doheny Assocs., Ltd. v. Shapiro* (2000) 83 CA4th 1380, 1389-1391, 1393-1394, 100 CR2d 478, 485-486, 488-489—triable issue of fact whether Ds' actions arose from corporate or personal matters; *Plate v. Sun-Diamond Growers of Calif.* (1990) 225 CA3d 1115, 1126, 275 CR 667, 673—indemnification order reversed since Ds were sued for actions performed in establishing their own business, independent of corporate employer; see *APSB Bancorp v. Thornton Grant* (1994) 26 CA4th 926, 928, 31 CR2d 736, 737 (*discussed at¶ 6:459.5*)]

(3) [6:441] **Successful defense on merits required:** Indemnification is mandatory only where the agent succeeds *on the merits* (*see¶ 6:439*). In the situation of a suit or other proceeding before a court, there must be a *judicial* determination of the actual merits of the defense raised. [*American Nat'l Bank & Trust Co. of Eau Claire, Wis. v. Schigur* (1978) 83 CA3d 790, 793, 148 CR 116, 117; *Groth Bros. Oldsmobile, Inc. v. Gallagher* (2002) 97 CA4th 60, 73, 118 CR2d 405, 415 (citing text)—tentative ruling sustaining demurrer without leave to amend constituted determination on merits notwithstanding plaintiff's attempt to thwart final ruling by involuntarily dismissing complaint]

(a) [6:441.1] **Lack of liability as determination on merits:** Indemnification is mandatory where the court establishes that the officer or director is *not liable*. The court need not determine that they are actually innocent of the alleged misconduct. [*Wilshire-Doheny Assocs., Ltd. v. Shapiro* (2000) 83 CA4th 1380, 1391, 100 CR2d 478, 487]

• [6:441.2] **Example:** Corporation sued former officers and agents for fraud and breach of fiduciary duties. Defendants prevailed on the theory that a mutual release executed by the parties barred Corporation's claims. Though the underlying fraud and breach of fiduciary duty claims were never resolved, the court's determination that defendants were *not liable* constituted a judgment on the merits of the lawsuit and hence entitled them to mandatory indemnification. [*Wilshire-Doheny Assocs., Ltd. v. Shapiro* (2000) 83 CA4th 1380, 1391-1392, 100 CR2d 478, 486-487]

[6:441.3 - 6:441.4] ***Reserved.***

(b) [6:441.5] **Compare—termination of administrative or investigative proceeding:** Where an administrative or investigative proceeding (*see¶ 6:436*) is withdrawn or terminated without a finding on the merits, an agent may likewise be entitled to mandatory indemnification even though the investigative or administrative body made no formal determination in the agent's favor. But no California appellate court has expressly so held. [See *In re SDR Capital Mgmt., Inc.* (BC ND CA 2008) 2008 WL 8188356, *4-5—indemnification of attorney fees mandatory where SEC investigation terminated after corporate agent presented strong defense in response to SEC letter stating agent "may" have violated securities laws (applying Corps.C. § 317(d)); *In re Landmark Land Co. of Carolina, Inc.* (4th Cir. 1996) 76 F3d 553, 561-568—corporate agents of bank holding company entitled to mandatory indemnification of attorney fees after federal banking regulators' investigation resulted in no charges (applying Louisiana law)]

(c) [6:442] **Compare—no mandatory indemnification following dismissal pursuant to settlement:** Indemnification is *not* mandatory where the complaint is dismissed pursuant to a pretrial settlement between the parties or there has otherwise been no determination on the merits of the officer's or director's defense. This is so even where the settlement represents a "win" for defendant. [*American Nat'l Bank & Trust Co. of Eau Claire, Wis. v. Schigur* (1978) 83 CA3d 790, 793, 148 CR 116, 117; *Dalany v. American Pac. Holding Corp.* (1996) 42 CA4th 822, 830, 50 CR2d 13, 17]

(4) [6:443] **Partial judgments:** But the officer or director does not have to win on every issue or claim. Indemnification is mandatory "to the extent that" the officer or director is successful on the merits (i.e., if successful as to *any claim or issue*, they are entitled to indemnification as to the expenses incurred in defending against such claim or issue). [Corps.C. § 317(d)]

[6:443.1 - 6:443.4] ***Reserved.***

(5) [6:443.5] **Officer's or director's "good faith" not an issue:** There is no "good faith" requirement as there is in circumstances where indemnification is permissive rather than mandatory (¶ *6:446, 6:457*). An officer or director who prevails on the merits is entitled to indemnification; their lack of "good faith" in performing the acts that were the subject of the proceeding is *irrelevant*. [*Wilshire-Doheny Assocs., Ltd. v. Shapiro* (2000) 83 CA4th 1380, 1393-1394, 100 CR2d 478, 488]

(6) [6:444] **Expenses:** The officer or director is entitled to expenses actually and reasonably incurred (including attorneys' fees, of course) in prevailing on the merits against the unfounded claim. And, if further litigation is necessary to establish their right to indemnification (e.g., suing the corporation to compel payment), they are entitled to whatever expenses are incurred in such further litigation as well. [Corps.C. § 317(a), last clause]

c. [6:445] **When indemnification *permissible:*** Absent a determination on the merits in defendant's favor, indemnification is not mandatory. It *may* be authorized, however, where the conduct of the officer or director seeking indemnification meets the statutory standards below (¶ 6:446 ff.). [Corps.C. § 317(b), (c)]

(1) [6:446] **In litigation other than suits by or on behalf of corporation:** In any civil, criminal, administrative or investigative proceeding *other than* a shareholders' derivative suit or a direct action by the corporation, the corporation *may* indemnify its officers and directors against litigation expenses *and liabilities*, provided:

- The proceeding was brought "by reason of the fact" they are or were corporate agents;
- They were acting "in *good faith* and in a manner the person *reasonably believed* to be in the *best interests of the corporation*"; and
- If criminal proceeding is involved, that they had "no reason to believe that their conduct was unlawful." [Corps.C. § 317(b)]

(a) [6:446.1] **Defendant must have acted on behalf of corporation:** Here again, indemnification is permissible only when the director's or officer's actions occurred *in connection with their performance of corporate duties*; *see¶ 6:440.5*.

(b) [6:447] **Good faith requirement:** Whether the director or officer was acting in good faith is a question of fact to be determined in each case (by the directors or shareholders, or court; *see ¶ 6:460 ff.*). [See *Fed-Mart Corp. v. Pell Enterprises, Inc.* (1980) 111 CA3d 215, 229, 168 CR 525, 533; *Plate v. Sun-Diamond Growers of Calif.* (1990) 225 CA3d 1115, 1126, 275 CR 667, 673]

1) [6:448] **No presumption of bad faith by reason of defeat:** But *no* presumption of bad faith or knowledge of illegality arises from the fact that the proceeding was lost or the claim was settled. "The termination of any proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent shall not, of itself, create a presumption that the person did not act in good faith …" [Corps.C. § 317(b)]

(c) [6:449] **Expenses *and liabilities:*** Indemnification may be authorized both for the expenses incurred in defense of the proceeding *and also* for whatever judgment or liabilities are assessed against the director or officer in such proceeding. [Corps.C. § 317(b)]

1) [6:450] **Expenses in defending proceeding:** The corporation may indemnify any agent who is a party (or *threatened* to be made a party) against all legal fees and other litigation expenses actually and reasonably incurred in connection with the proceeding. [Corps.C. § 317(b)]

2) [6:451] **Expenses in establishing right to indemnification:** The court hearing the case against the officer or director may order the corporation to indemnify them (*see¶ 6:463*). If such a court order is obtained, the officer or director will also be entitled to attorney fees and other expenses incurred (both in the trial court and on appeal) in establishing the right to indemnification—even if opposed by the corporation. [Corps.C. § 317(a), last clause; see *Fed-Mart Corp. v. Pell Enterprises, Inc.* (1980) 111 CA3d 215, 229, 168 CR 525, 533]

3) [6:452] **Liabilities:** In addition, they may be indemnified against any *fines or penalties, or judgments* returned against them, or any amounts paid out in settlement of the proceeding … and "other amounts actually and reasonably incurred in connection with the proceeding." [Corps.C. § 317(b)]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [6:453] **May be waived:** The articles or bylaws may restrict or prohibit indemnification against fines or penalties imposed against an officer or director. And, an officer or director who is convicted of a crime and accepts probation on condition that they *not* seek reimbursement from the corporation for fines paid, will be held to have waived the right to be indemnified. [See *Harper v. Kaiser Cement Corp.* (1983) 144 CA3d 616, 619-620, 192 CR 720, 723]

(2) [6:454] **Derivative suits and direct actions by corporation:** Indemnification is more limited in suits against an officer or director by the corporation itself or by a shareholder in a derivative suit (asserting some claim or right *on behalf of* the corporation).

(a) [6:454.1] **Indemnification mandatory where defendant prevails:** As in the situation of a suit by a third party against an officer or director, indemnification is *mandatory* where the officer or director wins a *judgment on the merits* in defense of a direct or derivative action. [Corps.C. § 317(d); *Wilshire-Doheny Assocs., Ltd. v. Shapiro* (2000) 83 CA4th 1380, 1390-1391, 100 CR2d 478, 486; *see*¶ *6:439*]

(b) Settlement of threatened or pending derivative suit

1) [6:455] **Threatened suits:** If a derivative action is *threatened* but not brought, indemnification is allowed for reasonable expenses of defending and settling the claim. Court approval is *not* required, so long as the expenditures were made in *good faith* (¶ 6:457) and believed to be in the *best interests of the corporation and its shareholders*. [Corps.C. § 317(c)]

2) [6:456] **Pending suits:** If the suit is filed but settled before judgment, the corporation may indemnify the defendants against their expenses, provided:

• The defendants were acting in *good faith* (¶ 6:457), in a manner they reasonably believed to be in the best interests of the corporation and its shareholders; and

• The settlement was made with *court approval*. [Corps.C. § 317(c)]

a) [6:456.1] **Expenses and settlement costs:** So long as the court approves, the defendants may be indemnified for expenses reasonably incurred in defending the action (including attorneys' fees) *and* for amounts paid in settling or otherwise disposing of the pending action. [Corps.C. § 317(c)(2) & (3)]

3) [6:457] **"Good faith":** Whether the director or officer was acting with the requisite "good faith" and "in a manner believed to be in the best interests of the corporation and its shareholders" is determined in each case by the board, independent legal counsel, the shareholders or the court (*see*¶ *6:460*).

(c) [6:458] **Judgment against defendant:** If a *derivative* action ends in a judgment determining that the officers or directors breached their duties to the corporation, indemnification is even more limited: The errant officers or directors may be indemnified only for their litigation *expenses*, and only then *if the court finds* that "in view of all the circumstances of the case, the person is fairly and reasonably entitled to indemnity for expenses …" [Corps.C. § 317(c)(1)]

I.e., if the officer or director *loses* a derivative action, the court alone (and not the shareholders or directors) can permit indemnification for litigation expenses.

(d) [6:459] **Indemnification of corporate officer as *plaintiff?:*** No California case has yet dealt with whether officers and directors may be indemnified for litigation expenses incurred as *plaintiffs;* e.g., where they file a derivative suit (on behalf of the corporation) against *other* directors for alleged damage to the corporation.

Such indemnification has been allowed, however, in some states. [See *Hibbert v. Hollywood Park, Inc.* (Del. 1983) 457 A2d 339, 343—Delaware indemnification statute did not prohibit bylaw provision permitting indemnification of ousted directors for legal fees incurred as plaintiffs in action to compel other directors to attend board meetings, etc.]

(3) [6:459.1] **Compare—insolvent corporations:** At least one bankruptcy court has found that a Chapter 11 debtor-corporation may not pay for counsel to represent *former* directors in securities litigation. Rationale: The bylaws do not constitute a contract between the corporation and its directors or officers; and such payments are not an "administrative expense" because any corporate obligations to former directors matured before the Chapter 11 filing. Moreover, priority could be given for such payments to *present* directors only if the payments were beneficial to the corporation's business operations (i.e., the corporation would benefit from the directors' continued service). [See *Matter of Baldwin-United Corp.* (SD OH 1984) 43 BR 443]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• [6:459.2] **Comment:** This decision emphasizes the desirability of providing directors and officers with liability insurance on an "occurrence" basis: They would be protected thereby even if the policy were cancelled by the insurer after a bankruptcy filing. (*See*¶ *6:470*.)

[6:459.3 - 6:459.4] ***Reserved.***

d. [6:459.5] **Indemnification of "agents":** Only "agents" are covered by the statutory indemnification provisions. Independent contractors and other third parties are "agents" where the activities for which they are sued were undertaken on behalf of the corporate principal "within the common law meaning of agency," rather than as independent contractors for personal benefit. [Corps.C. § 317(a); *Channel Lumber Co., Inc. v. Porter Simon* (2000) 78 CA4th 1222, 1228-1232, 93 CR2d 482, 487-490—law firm acting as litigation counsel was independent contractor and not "agent" entitled to indemnification for costs of successfully defending malpractice suit brought against it by corporation; *APSB Bancorp v. Thornton Grant* (1994) 26 CA4th 926, 928, 31 CR2d 736, 737—accounting firm performing audit services for bank was not "agent" entitled to indemnification for costs of successfully defending bank's allegations of negligently failing to uncover officer's embezzlement]

(1) [6:459.6] **Comment:** The decisions in *Channel Lumber* and *APSB Bancorp* are more a commentary on the courts' reluctance to award attorney fees in disputes between professionals and their clients than on the scope of indemnification under Corps.C. § 317 because in each case the courts' rationale for limiting the scope of coverage for such agents is labored.

e. [6:460] **How authorized:** Where indemnification is mandatory (defendant prevails on the merits), there is no need for separate authorization. The judgment itself (or other successful resolution of the proceeding) establishes the officer's or director's absolute right to be indemnified.

But where indemnification is only *permissive*, it must be authorized by or on behalf of the corporation. The determination of "good faith" and such other facts (*see* ¶ *6:446 ff.*) as are necessary to establish an officer's or director's right to indemnification must be made *either* by:

(1) [6:461] **Board action:** Indemnification may be authorized by majority vote of a quorum of directors, *excluding* the parties to be indemnified both as part of such majority and as part of the quorum required for the meeting. [Corps.C. § 317(e)(1)]

(2) [6:461.1] **By independent counsel:** If such a quorum of directors is not obtainable, indemnification may be authorized by the corporation's *independent* legal counsel, in a written opinion. [Corps.C. § 317(e)(2)]

(3) [6:462] **Shareholder action:** Alternatively, indemnification may be authorized by majority vote of shares represented and voting at a shareholders' meeting at which a quorum is present (Corps.C. § 153, ¶ *6:8*); or upon written consent by a majority of the outstanding voting shares (Corps.C. § 603, ¶ *6:154*). Shares owned by the persons to be indemnified are *not* entitled to vote or consent (but may be included in determining a quorum). [Corps.C. § 317(e)(3)]

(*Limitation:* If the indemnification is based on written consents, notice of shareholder approval by consent must be given to all shareholders who were not asked for their consents at least 10 days before the indemnification is effective; see Corps.C. § 603(b), ¶ *6:166*.)

(4) [6:463] **Court order:** Finally, indemnification may be authorized by the court in which the litigation was pending. Court authorization may be sought either by the corporation, or by the defendants, or their attorneys or other persons rendering services in connection with their defense. [Corps.C. § 317(e)(4)]

(a) [6:464] **Comment:** Court authorization for indemnification is normally sought by a defendant if the corporation is hostile and is refusing to indemnify them.

If the defendant is successful, they will also be entitled to recover reasonable expenses in obtaining such order. [Corps.C. § 317(a), last clause; see *Fed-Mart Corp. v. Pell Enterprises, Inc.* (1980) 111 CA3d 215, 222, 168 CR 525, 528]

f. [6:464.1] **Indemnification *exceeding statutory limits:*** The articles of incorporation may authorize the corporation—through the bylaws, agreement or otherwise—to indemnify its agents from liability for their acts or omissions, including liability for breaches of their duties *to the corporation and its shareholders*, *in excess* of that permitted by Corps.C. § 317 (¶ 6:436 ff.). [Corps.C. §§ 204(a)(11), 317(g); *see*¶ *4:88.1 ff.*]

(1) Limitations

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [6:464.2] **Indemnification prohibited by statute:** However, the articles may not permit corporate agents to be indemnified where indemnity is expressly prohibited by Corps.C. § 317. [Corps.C. § 204(a)(11)]

Thus, for example, there can be no indemnity for an agent adjudged liable to the corporation (except for defense costs, where the court awards them; see Corps.C. § 317(c)(1), ¶ *6:458*). Likewise, indemnification cannot be authorized for amounts paid in defending or settling pending derivative actions *without* court approval (see Corps.C. § 317(c)(2) & (3); ¶ *6:456*).

(b) [6:464.3] **Highly culpable misconduct:** Nor may agents be indemnified for that type of *egregious* misconduct as to which directors may not be relieved of damages liability (see Corps.C. § 204(a)(10); ¶ *6:250.6*). [Corps.C. § 204(a)(11)]

(2) [6:464.4] **Comment—limited application of "expanded" indemnification rights:** It is unclear when, if ever, indemnification can *exceed* that expressly permitted by Corps.C. § 317, and yet not be expressly *prohibited* by it or by Corps.C. § 204(a)(11) (¶ 6:464.2 ff.). It appears that the main practical effect of an articles provision authorizing "expanded indemnification" is to allow the corporation to make the *indemnification process* more favorable to the indemnitees. For example, corporate bylaws or agreements might provide for:

• *Mandatory* indemnification where not expressly prohibited by statute;

• *Mandatory advancement* of expenses payable to the indemnitee on demand in specified instances;

• *Accelerated procedures* for the "determination" required by Corps.C. § 317(e) to be made "in the specific case" (i.e., "that indemnification of the agent is proper in the circumstances"); and

• "*Appeal*" rights and procedures in the event of an unfavorable "determination."

(a) [6:464.5] **Public corporations main beneficiaries:** These types of provisions will primarily benefit *publicly held corporations*. This is because their directors, officers and shareholders typically run the highest risk of shareholder derivative and class actions, and are the most likely to seek additional protection.

[6:464.6 - 6:464.9] ***Reserved.***

g. [6:464.10] **No "vesting" of indemnification rights:** A Delaware court held that the right to advancement of expenses did not "vest" when the director took office, and thus the board of directors, by amendment to the bylaws, could eliminate a *former* director's right to advancement after the event for which advancement was sought took place. [*Schoon v. Troy Corp.* (Del.Ch. 2008) 948 A2d 1157, 1166-1167]

(*Note:* In response to the *Schoon* decision, Delaware law was amended to provide that the right to indemnification or advancement of expenses cannot be eliminated or impaired by an amendment to the bylaws or certificate of incorporation adopted after the occurrence of the act or omission for which indemnification or advancement is sought unless the bylaws or articles, at the time of the act or omission, explicitly authorized such elimination or impairment; see 8 Del.C. § 145(f).)

➪ [6:464.11] ***PRACTICE POINTER:*** To protect against potential termination of indemnification (and advancement) rights, a director may wish to enter into an agreement with the corporation providing that indemnification rights remain in force for some term (typically, 10 years or more) regardless of future changes to the bylaws or articles and changes to the make-up of the board.

h. [6:465] **Compare—advancing defense costs:** Regardless of any right to actual indemnification, the corporation may properly advance defense costs to officers or directors *if they agree to repay* such advances in the event it is ultimately determined they are not entitled to indemnification. [Corps.C. § 317(f); but see *Johnson v. Couturier* (9th Cir. 2009) 572 F3d 1067, 1078-1081—federal district court did not abuse its discretion in enjoining corporation from advancing defense costs to corporate directors who breached ERISA fiduciary duties in administering employee stock ownership plan (*see*¶ *6:256.5*)]

Such advances are not considered officer or director "loans" requiring shareholder approval under Corps.C. § 315 (*discussed at*¶ *6:471 ff.*). [Corps.C. § 317(f)]

i. [6:466] **Compare—liability insurance ("D & O coverage"):** A corporation may properly purchase and maintain insurance for its directors and officers, to protect them against any liability which they incur in serving the corporation … *including*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

liabilities for which the corporation could not lawfully indemnify them (e.g., fines, penalties or judgments against them, ¶ 6:464.2 ff.). [Corps.C. § 317(i); see also Corps.C. § 2702(d) (SPCs, ¶ *9:148*)]

Such insurance protection is commonly called “directors' and officers' liability insurance,” or more simply, “D & O coverage.” Usually, it insures (1) the *corporation* against any amounts it may be required to pay to indemnify the directors and officers or in furnishing them a defense, and (2) the *directors and officers* directly (commonly referred to as “Side A coverage”) in the event the corporation is unable to indemnify them (e.g., is insolvent) or refuses to do so.

(1) [6:467] **Comment:** When available, such insurance serves a vital function because it enables persons to accept corporate office without worry that they may be sued and have to defend themselves out of their own pockets (especially if the corporation becomes *insolvent*, making indemnification worthless). [See *August Entertainment, Inc. v. Philadelphia Indemnity Ins. Co.* (2007) 146 CA4th 565, 572-573, 52 CR3d 908, 912-913]

However, allowing a corporation to provide such insurance protection to its officers and directors is subject to this criticism: It enables the corporation to do indirectly (by paying insurance premiums) that which it could *not* do directly (indemnifying officers and directors against their own wrongdoing).

(2) [6:468] **Coverage limited:** As a practical matter, “D & O” insurance usually covers only *negligent* misconduct by directors and officers. Most policies specifically *exclude* liability arising from “dishonesty,” “fraud” or intentional wrongdoing by management. Under these policies, directors might *not* be insured against liability for many kinds of egregious misconduct (“seven deadly sins”; *see*¶ *6:250.6*).

[6:469] **Caution:** A “fraud” exclusion may cause problems where directors or officers are sued for federal *securities laws violations* … because under those laws, the term “fraud” includes reckless, as well as deliberate, misrepresentations. [See *Nelson v. Serwold* (9th Cir. 1978) 576 F2d 1332, 1337; *Raychem Corp. v. Federal Ins. Co.* (ND CA 1994) 853 F.Supp. 1170, 1179-1180]

➪ [6:470] ***PRACTICE POINTERS:*** If you represent a corporation considering the purchase of such insurance, review the terms carefully with management. Focus on the following matters:

- Whether coverage is limited to named officers and directors, or to any person appointed to designated offices. (The latter saves having to amend the policy every time a new person is elected to office; and if you forget, there may be no coverage.)

- The “retention” or percentage of liability which the insured must bear.

- Whether coverage is provided on a “claims made” or “occurrence” basis. (“Claims made” policies are more common, but are less desirable: They do not protect against claims arising after the policy terminates, and there is usually a specific exclusion for claims made, pending or threatened before the policy goes into effect.)

- Whether the insurer retains the right to cancel during the term of the policy for reasons other than nonpayment of the premium. (If the insurer has this right, consider purchasing a rider to provide coverage as to any matter arising *before* it cancels. Otherwise, if several potential claims have arisen, your notifying the insurer as to any of them may prompt it to cancel in order to avoid liability on the others.)

- The respective rights and obligations of the parties to defend the action. (A “duty to defend” policy broadly obligates the insurer to obtain counsel and to determine when an investigation or defense should commence in response to a claim or occurrence. Other policies leave this burden upon the corporation and, further, will not advance defense costs, but only reimburse the corporation for costs actually paid.)

- The extent to which the corporation can control settlement and defense.

- Whether the policy is “self-consuming” (i.e., defense costs are counted toward the coverage limits). [See generally, *Helfand v. National Union Fire Ins. Co. of Pittsburgh, Penn*. (1992) 10 CA4th 869, 880-885, 13 CR2d 295, 299-303; *Xebec Develop. Partners, Ltd. v. National Union Fire Ins. Co. of Pittsburgh, Penn*. (1993) 12 CA4th 501, 529, 565-566, 15 CR2d 726, 739, 762-763 (disapproved on other grounds by *Essex Ins. Co. v. Five Star Dye House, Inc.* (2006) 38 C4th 1252, 1265, 45 CR3d 362, 371, fn. 4)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(3) [6:470.1] **Corporation can control insuring company:** A corporation can in effect "self-insure" its agents' indemnification by partly or even wholly owning the company issuing the "D & O" insurance. This can be accomplished in one of two ways:

(a) [6:470.2] **Authorized in articles:** First, the *articles* can provide for such "captive" indemnity insurance provided they also authorize expanded indemnity (*see*¶ *6:464.1 ff.*). But any policy issued may *not* provide for indemnification where it is otherwise prohibited by law (*see*¶ *6:464.2*). [Corps.C. § 317(i)(1); see also Corps.C. § 2702(d)(1) (SPCs)]

(b) [6:470.3] **Not authorized by articles:** If the articles do not authorize such insurance, a corporation can insure through a "captive" insurer only if:

- The insuring company is duly licensed and in compliance with the laws of the jurisdiction in which it is organized; and

- The insuring company's procedures prevent the insured corporation from directly controlling the insurer's claims processing; and

- The insurance policy provides for some manner of risk sharing by an *unaffiliated person* (e.g., requiring some unaffiliated ownership of the insuring company, or that some of the coverage be reinsured with an unaffiliated insurer). [Corps.C. § 317(i)(2); see also Corps.C. § 2702(d)(2) (SPCs)]

1) [6:470.4] **Comment:** These conditions are imposed to prevent a corporation from being both in *sole control* of its own indemnity claims and *solely and entirely at risk* on them. However, it is not clear just how much risk sharing by an unaffiliated person is required.

3. [6:471] **Borrowing and Lending:** Loan transactions with third parties (outsiders) typically require board approval (*see*¶ *6:485*).

Additionally, as discussed below (¶ 6:472 ff.), loans to (or borrowings from) officers and directors raise conflict of interest issues, requiring specific board approval (¶ *6:290*) and potential shareholder approval.

a. [6:472] **Loans or guarantees for officers and directors:** In general, shareholder—as well as board—approval is required for the corporation to loan money or property (or guarantee third-party loans) to any officer or director of the corporation or its parent (but not of its subsidiaries). [Corps.C. § 315(a)]

(*Note:* There is no comparable requirement for loans to *shareholders,* unless they are officers or directors, or the loans are secured by their shares, are nonrecourse (*see*¶ *6:483*), and are not otherwise adequately secured; Corps.C. § 315(c), *see*¶ *6:483*.)

(1) [6:473] **"Shareholder approval":** For purposes of corporate-insider loan and guarantee transactions, approval by *a majority of the shareholders entitled to act thereon* is required. [Corps.C. § 315(a), (c)] This means *either:*

- *Written consent* by a majority of the *outstanding shares* having voting rights; or

- The affirmative vote of a majority of the voting shares present and voting at a duly held meeting at which a quorum is present. [Corps.C. § 315(g)]

(a) [6:473.1] **Shares held by interested officers and directors not counted:** Shares owned by any officer or director eligible to participate in the transaction or plan are *not counted*, whether the plan is approved by written consent or by a vote at a duly held meeting. [Corps.C. § 315(g)]

(b) [6:473.2] **Interested officers' and directors' shares counted in determining quorum:** However, where the shareholder approval is by a vote at a meeting, shares owned by interested officers or directors *are counted* to determine whether a quorum is present. (Of course, such interested shareholders are not entitled to vote, ¶ 6:473.1.) [Corps.C. § 315(g)]

(Note: This differs from normal practice under the Code, which requires that shares owned by interested parties be *excluded* from calculation of the required quorum. Corps.C. §§ 112, 153; *and see*¶ *6:8, 6:11.1*.)

(c) [6:473.3] **Lack of majority:** Sometimes, excluding from voting the shares held by officers or directors eligible for such loans will make it impossible to obtain a majority vote of outstanding voting shares (this is especially true in closely held corporations). If this occurs, the loans or guarantees may be authorized by *unanimous* vote or *written consent* of *all* the shareholders (including the interested shareholders). [Corps.C. § 315(g)]

(d) [6:473.4] **Effect of articles provisions:** Only shares entitled under the articles to vote on all matters before the shareholders (which means all shares, unless the articles contain specific voting restrictions; *see¶ 3:78*), or specifically entitled to vote on insider loans or guarantees, must approve the transaction. If the corporation has more than one class or series of voting shares outstanding, separate class or series voting is necessary only if required by the articles. [Corps.C. § 315(g)]

(e) [6:474] **Compare—interested nonofficer or nondirector shareholders entitled to vote?**Corps.C. § 315(g) does not specifically disqualify from voting interested shareholders who are neither directors nor officers. Thus, it appears that where the transaction being voted on is a loan to such a shareholder, secured by their shares, the shareholder may vote such shares for approval of the transaction. [See Corps.C. § 315(c), (g)]

(2) [6:475] **Compare—employee stock purchase loans:** Loans (or guarantees) made to officers, directors or other employees under an employee stock purchase plan to help them acquire shares in the corporation may be authorized by the board alone, *without* any shareholder approval (provided the plan or agreement has been adopted pursuant to Corps.C. § 408; *see¶ 3:309, 6:406.1, 6:483*). It makes no difference whether such loans are secured by the purchased shares or unsecured; whether they are recourse or nonrecourse; or whether they are limited to a single executive or made pursuant to a plan covering many employees (*see¶ 6:406.3 ff.*). [Corps.C. § 315(f)(1)]

(3) [6:475.1] **Compare—loans from other employee benefit plans:** Loans to officers or directors from funds in employee benefit plans, which are not made pursuant to an employee stock purchase plan (¶ 6:475), may also be authorized by the board alone (without specific shareholder approval), *provided* the shareholders had *previously approved such plan* after disclosure to them of the officers' and directors' participation therein. (Shares held by officers or directors eligible to participate in the plan are excluded in obtaining such shareholder approval.) [Corps.C. § 315(a)]

[6:475.2] There are *limitations* on the *amounts* that can be borrowed from a tax-qualified retirement plan without subjecting the borrowing employee to current taxation. [IRC § 72(p)]

(4) [6:476] **Compare—officer-loans by corporations with 100 or more shareholders:** Similar flexibility is permitted for loans to *officers* (whether or not directors—but not to directors alone) of corporations with 100 or more shareholders. Shareholder approval is not required if *bylaws* previously adopted by a majority of the outstanding shares specifically:

• Authorize such loans or guarantees to corporate officers by the board alone; or

• Authorize the board to adopt an employee benefits plan providing for such loans or guarantees by board action alone.

In either case, the board must determine (without counting the vote of any "interested" director) that the loan or guarantee or plan may "*reasonably be expected to benefit the corporation.*" [Corps.C. § 315(b)]

Caution: Corporations subject to the 1934 Act reporting requirements or with registration statements pending before the SEC are prohibited from making personal loans to executive officers; *see ¶ 6:482.5*.

➪ [6:476.1] ***PRACTICE POINTER:*** To take advantage of the greater flexibility accorded to them, corporations with 100 or more shareholders should be sure their bylaws authorize officer loans or guarantees (or employee benefit plans) by board action alone, and that such bylaws have been *approved by a majority of the outstanding shares*.

➪ [6:477] ***PRACTICE POINTER:*** Where the board acts without shareholder approval under the above provisions (¶ 6:475 ff.), it should do so by formal resolution, setting forth *facts* (rather than mere conclusions) showing the benefit to the corporation.

(5) [6:478] **Compare—certain advances not requiring shareholder approval:** The following types of advances by a corporation to its officers or directors do *not* require shareholder approval:

• Monies advanced to an officer or director to cover *reimbursable expenses;* [Corps.C. § 315(d)]

• Premiums paid on an officer's or director's *life insurance* (i.e., "split-dollar") policies, if repayment of such premiums to the corporation is secured by the policy proceeds or cash surrender value. [Corps.C. § 315(e)]

(It does not matter for purposes of this section whether the policy is owned by the corporation or the insured officer or director.)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(6) [6:478.1] **Other loan transactions excluded:** These loan transactions are also excluded from the shareholder approval requirements of section 315:

- Loans (or guarantees) made to officers or directors by a corporation that makes loans "in the ordinary course of its business," provided such loans are expressly regulated by other laws (e.g., regulated finance companies). [Corps.C. § 315(f)(3)]

- Officer or director loans (or guarantees) made by any "depository institution" (see 12 USC § 3201). [Corps.C. § 315(f)(2)]

(7) [6:479] **Directors personally liable where requisite shareholder approval not obtained:** Loans or guarantees for officers and directors made without required shareholder approval are treated as *illegal distributions.* Directors who approve (or fail to vote against) such loans are jointly and severally liable to creditors or shareholders damaged thereby. [Corps.C. § 316(a)(3); *and see¶ 7:141*]

(8) [6:480] **Tax considerations:** Notwithstanding the formalities required (¶ 6:473), corporate loans to officers and directors may be desirable from a tax-planning standpoint: As long as the loans are bona fide, the amounts received are not income and therefore not subject to taxation.

But there may be offsetting tax considerations:

- [6:481] First of all, the corporation gets no deduction for payments made as loans to its executives (so the tax advantage is one-sided).
- [6:482] Also, if loans are made on unreasonably favorable terms (e.g., no or low interest, unsecured and long maturity), the IRS may treat them as a form of additional compensation—and thus taxable income to the officers and directors. [*Dean v. Commr.* (1961) 35 TC 1083; and see *Dickman v. Commr.* (1984) 465 US 330, 335-338, 104 S.Ct. 1086, 1090-1091]

[6:482.1 - 6:482.4] ***Reserved.***

(9) [6:482.5] ***Caution—no loans by public corporations:*** A corporation that is subject to the 1934 Act reporting requirements or that has a registration statement pending before the SEC (*see¶ 5:54 ff.*) is prohibited from directly or indirectly (e.g., through a subsidiary) extending or arranging credit in the form of a personal loan to or for any of their *directors or executive officers* (regardless of whether the transaction receives disinterested shareholder approval). [SEA § 13(k) (15 USC § 78m(k))]

b. [6:483] **Loans or guarantees secured by corporation's shares:** Shareholder approval (*see¶ 6:473 ff.*) is also required for corporate loans or guarantees to *any* borrower (not just officers and directors) that are *secured by shares of the corporation* and are "nonrecourse" (i.e., upon default, the corporation may recover only against the security for the loan, not against the borrower personally), *unless* the loan is:

- Otherwise adequately secured; or

- Made pursuant to an employee stock purchase or option plan permitted by Corps.C. § 408. [Corps.C. § 315(c), (f)(1)]

c. [6:484] **Corporate borrowings:** Corporate action is also frequently required in connection with borrowings by the corporation. Several issues may arise:

(1) [6:485] **Authorization:** Even if the officers of the corporation have express authority to borrow on the corporation's behalf, many lenders (particularly banks) require formal board action approving such borrowing, to eliminate any question as to the officer's agency powers.

➪ [6:486] ***PRACTICE POINTER:*** Many lenders require adoption of their own form resolutions authorizing the corporation's borrowing. Thus, rather than prepare your own resolution, it is often necessary to adopt and include in the minutes a copy of the lender's form borrowing resolution.

(2) [6:487] **Liability of shareholders, insiders:** The officers, directors or shareholders may be personally liable for monies borrowed by the corporation, on any of several theories:

- [6:488] If the corporation lacks credit worthiness, the lender will no doubt insist on personal *guaranties* by the officers, directors and shareholders.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• [6:489] If there is any *ambiguity* as to whom the loan was made, the officers signing the loan may be held personally liable for its repayment, notwithstanding that the funds were used for corporate purposes. For example, a loan signed "John Jones, of XYZ Corporation" may be treated as a personal loan to Jones. (*See*¶ *6:283.1 ff.*)

• [6:490] Finally, if the corporation is not adequately capitalized, and there are elements of fraud or injustice involved, the lender may seek to hold the shareholders personally liable as the "*alter ego*" of the corporation (*see*¶ *2:50*).

(3) [6:491] **Borrowing from insiders:** Special issues arise where the corporation borrows money from its own directors, officers or shareholders:

(a) [6:492] **Conflict of interest:** Conflict-of-interest issues may arise where a corporation borrows money from an officer or director. Questions may arise as to the "reasonableness" of the interest charged, security required, or other terms of the loan. In general, the transaction will be upheld as long as approved by a disinterested majority of the directors or shareholders, having knowledge of all material facts regarding the loan. [Corps.C. § 310(a); *see*¶ *6:290*]

(b) [6:493] **Tax considerations—"debt" vs. "equity":** Interest paid by the corporation is normally deductible for tax purposes. But where paid to shareholders, the transaction may be scrutinized carefully by the IRS. The issue, of course, is whether the shareholder loan to the corporation is bona fide corporate "debt" or is part of the shareholders' "equity" investment; i.e., whether the "interest" paid by the corporation is a "disguised" dividend to the shareholder-lender. [IRC § 385; *see*¶ *3:41 ff.*]

4. [6:494] **Corporate Records:** Shareholders and directors have rights of access to the corporate records. No formal action by the shareholders as a group or by the board of directors is required. Rather, inspection rights exist as a matter of law, as to the following types of records and under the following circumstances:

a. [6:495] **Records required by statute:** All corporations are required to keep and maintain at least the following records:

• [6:496] **Accounting records:** "Adequate and correct" books and records of account must be kept in writing or another form capable of being converted into "clearly legible tangible form" (e.g., computer entries). [Corps.C. § 1500]

• [6:496.1] **Tax records:** For tax purposes, a corporation is required to maintain "permanent books of account or records, including inventories, as are sufficient to establish" the information required on its tax returns. [IRC § 6001; Treas.Reg. § 1.6001-1]

• [6:497] **Shareholders' list:** Records must be kept stating the names and addresses of each shareholder, and the number and class of shares held by each. Again, the records must be in writing or a form convertible into "clearly legible tangible form." Such records must be kept at the corporation's principal office (inside or outside California) or at the office of its transfer agent or registrar. [Corps.C. § 1500]

• [6:498] **Minutes:** Corporations must also keep, in written form, "minutes of the proceedings of its shareholders, board and committees of the board." [Corps.C. § 1500]

• [6:499] **Bylaws:** The original or a copy of the corporation's bylaws must be maintained at the corporation's principal office or business office in California. [Corps.C. § 213]

b. [6:500] **Directors' inspection rights:** To properly discharge their fiduciary duties, directors have the right to inspect, at any reasonable time, all corporate books, records and documents of any kind, as well as the corporation's physical properties. This right is *absolute*—i.e., a director need not assert a "proper purpose" for the inspection—and includes the right to make copies or extracts. Inspection may be demanded by the board acting as a group, *or by any director individually,* and may be conducted in person or by agent or attorney. [Corps.C. § 1602; see *Havlicek v. Coast-to-Coast Analytical Services, Inc.* (1995) 39 CA4th 1844, 1851-1852, 46 CR2d 696, 699-700 (contrasting § 1602 with Del.Gen.Corp.L. § 220(d) limiting director's inspection rights to purpose "reasonably related to the director's position as a director")]

(1) [6:501] **Which corporations:** Directors have the right to inspect the records of the corporation on whose board they serve, and also the records of any *subsidiary*. [Corps.C. § 1602]

Out-of-state corporations having their principal office in California or "customarily holding" board meetings here are also subject to these requirements. [Corps.C. § 1602; see *Havlicek v. Coast-to-Coast Analytical Services, Inc.* (1995) 39 CA4th 1844, 1852-1855, 46 CR2d 696, 700-701—§ 1602 does not violate Commerce Clause, Full Faith and Credit Clause or corporate "internal affairs" doctrine (¶ *3:4.1 ff.*)]

(2) [6:502] **Enforcement by court action:** If necessary, directors can enforce their inspection rights by court action (under the same conditions governing shareholders' inspection rights, *¶ 6:516 ff.*). [*Havlicek v. Coast-to-Coast Analytical Services, Inc.* (1995) 39 CA4th 1844, 1856, 46 CR2d 696, 702 (citing text)]

(a) [6:502.1] **Court-imposed limits on inspection rights:** Although the directors' inspection right is "absolute" (*¶ 6:500*), courts may nevertheless impose "just and proper conditions" on the inspection. [Corps.C. § 1603(a)]

1) [6:502.2] **Breach of fiduciary duty causing harm to corporation:** A director may not invoke the "absolute" inspection right as a ploy to breach their fiduciary duty and cause harm to the corporation (e.g., gaining access to confidential customer lists to set up competing business). Thus, a protective order may be granted to limit the inspection where the corporation establishes, by a preponderance of the evidence, the director's *clear intent* to use the documents to commit an *egregious tort*—i.e., one that cannot be easily remedied by subsequent monetary damages—against the corporation. [*Havlicek v. Coast-to-Coast Analytical Services, Inc.* (1995) 39 CA4th 1844, 1856, 46 CR2d 696, 702; *Saline v. Sup.Ct. (Commonwealth Energy Corp.)* (2002) 100 CA4th 909, 915, 122 CR2d 813, 817]

However, a director's inspection right cannot be curtailed based on the mere *possibility* that information *could* be used to harm the corporation. Thus, a conflict of interest or adversarial position in litigation, without more, is *not* sufficient to defeat the right. [See *Fowler v. Golden Pac. Bancorp, Inc.* (2022) 80 CA5th 205, 222, 295 CR3d 501, 513]

2) [6:502.3] **Documents covered by corporate attorney-client privilege:** Although a director's inspection right extends to documents protected by the corporation's attorney-client privilege, privileged documents generated in defense of the *director's damages suit against the corporation* may be shielded from inspection. "In this situation, a court may properly limit a director's inspection rights because the director's loyalties are *divided* and documents obtained by a director in [their] capacity as a director could be used to advance the director's *personal* interest in obtaining damages against the corporation." [*Tritek Telecom, Inc. v. Sup.Ct. (Mak)* (2009) 169 CA4th 1385, 1387, 1391, 87 CR3d 455, 457, 459 (emphasis added); see *La Jolla Cove Motel & Hotel Apts., Inc. v. Sup.Ct. (Jackman)* (2004) 121 CA4th 773, 785-786, 17 CR3d 467, 476 (*discussed at¶ 6:612d*)]

(3) [6:503] **Validity of limitations imposed by articles/bylaws:** The articles or bylaws cannot limit directors' inspection rights. Although the Code does not expressly so provide, it seems clear that any provision purporting to do so would be void as contrary to public policy (just as in the case of shareholders' inspection rights; *see¶ 6:519*).

[6:503.1 - 6:503.4] ***Reserved.***

(4) [6:503.5] **Compare—former directors:** Ordinarily, former directors have no right to inspect corporate records. This is so even where the director asserted the inspection right and filed suit to enforce that right before their term expired. To enforce the Corps.C. § 1602 inspection rights (¶ 6:502), the individual must have standing as a director *until judgment is entered* and not just on the date suit is filed. [*Wolf v. CDS Devco* (2010) 185 CA4th 903, 917-919, 110 CR3d 850, 860-862]

(a) [6:503.6] **Inspection rights where former director faces potential liability:** A former director might have a right to inspect corporate records to the extent necessary to protect against personal liability arising from their term in office. At the pleading stage, the former director must set forth *facts* supporting potential liability and make a showing that the business judgment rule would not likely avert liability. [*Wolf v. CDS Devco* (2010) 185 CA4th 903, 922, 110 CR3d 850, 864-865 (but finding plaintiff failed to show facts supporting allegations of potential personal liability)]

c. [6:504] **Shareholder inspection rights:** Shareholders also have certain statutory rights to inspect corporate records and properties. And where the stock is community property, *spouses* share equal rights of inspection even though only one of them is the shareholder of record. [*Schnabel v. Sup.Ct. (Schnabel)* (1993) 5 C4th 704, 715-716, 21 CR2d 200, 206]

However, shareholders (unlike directors) are not fiduciaries and therefore do not have absolute inspection rights. Rather, the shareholders' inspection rights depend on the *type* of records sought to be inspected; and, in certain cases, on the *purpose* of the desired inspection. Likewise, the validity of limitations on such inspection rights depends on the type of record sought to be inspected.

(1) [6:505] **Bylaws:** As to the corporation's bylaws, the right of inspection is *absolute*: i.e., shareholders (collectively or individually) have the right to inspect the bylaws during office hours at the corporation's principal office. (If the office is outside California, and it has no business office here, the corporation must furnish copies of the bylaws to the shareholders on demand.) [Corps.C. § 213]

(2) [6:506] **Accounting books, corporate records and shareholder and director minutes:** The shareholders also have a *limited* right to inspect the corporation's accounting books and other corporate records, as well as minutes of proceedings of the shareholders, board and board committees: Such records and minutes are open to inspection upon *written* demand showing a "*purpose reasonably related* to the holder's interests as a shareholder …" [Corps.C. § 1601(a)(1) (emphasis added); see *Schnabel v. Sup.Ct. (Schnabel)* (1993) 5 C4th 704, 717, 21 CR2d 200, 207—"right of inspection does not extend to records not reasonably related to the proper purpose for which it is sought"]

(a) [6:507] **Which corporations:** The inspection right is enforceable as to any California corporation. It also extends to any out-of-state corporation keeping any records here or having its principal office here, and to each of its subsidiaries. [Corps.C. § 1601(a)(1), (3)]

1) [6:507.1] **Effect of internal affairs doctrine:** In California, a shareholder's right to inspect corporate records is *not* considered a matter of "internal affairs." Accordingly, shareholder inspection rights are not subject to the "internal affairs" doctrine (¶ 3:4.1) and are governed by the law of the state where a corporation operates. [*Valtz v. Penta Investment Corp.* (1983) 139 CA3d 803, 807, 188 CR 922, 924-925—shareholders who owned more than 5 percent of stock in Delaware corporation with its sole executive office in California had "absolute right" to inspect and copy shareholder list under California law because "the inspection of shareholder lists is a right incidental to the ownership of stock, affects the relationship between corporation and shareholder, and is thus subject to regulation by statute where the corporation does business" (*discussed at*¶ 6:527)]

a) [6:507.2] **Caution—subject to internal affairs doctrine in Delaware:** In Delaware, however, shareholder inspection rights *are* considered a matter of "internal affairs." Accordingly, the rights of shareholders of a company incorporated in Delaware to inspect the company's books and records are subject to the "internal affairs" doctrine (¶ 3:4.1) and governed by Delaware law (the law of the state of incorporation). This means that a shareholder of a company that is incorporated in Delaware and has its principal place of business in California may *not* be able to rely on Corps.C. § 1601 to inspect the company's books and records. [*Juul Labs, Inc. v. Grove* (Del. Ch. 2020) 238 A3d 904, 918—stockholder of Delaware corporation with its principal place of business in California cannot seek inspection under Corps.C. § 1601 because rights governed by Delaware law]

While the court in *Juul* dismissed *Valtz* (¶ 6:507.1) as "unpersuasive," the court acknowledged that "a substantial volume of authority posits that the internal affairs doctrine should *not* limit the ability of a non-chartering jurisdiction to grant rights to inspect the books and records of a foreign corporation." [*Juul Labs, Inc. v. Grove*, supra, 238 A3d at 913, 915, fn. 7, 9 (emphasis in original)]

(b) [6:507.3] **Who can exercise shareholder inspection rights:** Only shareholders and holders of voting trust certificates can exercise inspection rights under Corps.C. § 1601. A "shareholder" means someone who is a "holder of record of shares." [Corps.C. § 185 (defining "shareholder"); see Corps.C. § 101 (general provisions and definitions apply unless otherwise required by statutory provision or context); *Ramirez v. Gilead Sciences, Inc.* (2021) 66 CA5th 218, 221, 223, 280 CR3d 748, 750, 752 & fn. 2—registered owner or record holder "holds shares directly with the company"]

1) [6:507.4] **Beneficial owners are excluded:** Beneficial owners of stock cannot exercise shareholder inspection rights under Corps.C. § 1601 because they do not hold shares directly with the company. Rather, they hold shares indirectly, e.g., through a bank or broker-dealer. [*Ramirez v. Gilead Sciences, Inc.* (2021) 66 CA5th 218, 221, 223-224, 280 CR3d 748, 750, 752 & fn. 2—beneficial owner of corporation's stock lacks standing to assert inspection demand under Corps.C. § 1601]

(c) [6:508] **Which records:** Prior to 2019, Corps.C. § 1601(a) gave shareholders the right to inspect only the "*accounting books and records*" (as well as shareholder and director minutes) of the corporation or any subsidiary. There was no statutory right to inspect other corporate records. [See former Corps.C. § 1601(a) (emphasis added); also see *Bezirdjian v. O'Reilly* (2010) 183 CA4th 316, 328, 107 CR3d 384, 395-396—former § 1601(a) does not grant plaintiff shareholder right to discover corporate records in ongoing lawsuit (¶ *6:639.3*)]

Effective January 1, 2019, Corps.C. § 1601(a) was amended to grant shareholders the right to inspect "accounting books, records, and minutes …" A plain reading of this phrase suggests that the inspection right is no longer limited to *accounting* books and records, but now conceivably encompasses *all* corporate records. The legislative history sheds no light on whether the drafters of the amendment intended to effect such a sweeping expansion of shareholder inspection rights. Undoubtedly the more sensible reading of the text is that "accounting" should qualify both "books"

and "records." [Corps.C. § 1601(a)(1); see, e.g., Assembly Floor Analysis (6/15/18) of A.B. 2237; Senate Floor Analyses (6/7/18) of A.B. 2237; *and* ¶ *6:515.1*]

1) [6:508.1] **Form of records:** If the sought-after records are not maintained in written form (e.g., stored on computers), the corporation must nevertheless produce them in writing at its own expense. [Corps.C. § 1605]

But this is as far as the corporation's obligation extends. In the case of, e.g., accounting records, the corporation need *not prepare financial reports* or *deliver* accounting records to the shareholder; the shareholder's right is solely to *inspect* such records as they then exist. [*Jara v. Suprema Meats, Inc*. (2004) 121 CA4th 1238, 1263, 18 CR3d 187, 206; see *Innes v. Diablo Controls, Inc.* (2016) 248 CA4th 139, 143, 203 CR3d 375, 377; *Singhania v. Uttarwar* (2006) 136 CA4th 416, 430-431, 38 CR3d 861, 871-872]

2) [6:509] **Compare—directors' inspection rights:** The directors have statutory rights to inspect "*all* books, records *and documents of every kind,*" as well as the corporation's *physical properties*. (Shareholders have *no statutory right* to inspect the corporation's physical plant or properties.) Additionally, these rights are "absolute"—i.e., a director need not show a "proper purpose." [Corps.C. § 1602 (emphasis added); *see* ¶ *6:500*]

It is not clear what distinction, if any, exists between the shareholders' right to inspect corporate "accounting books, records, and minutes" (Corps.C. § 1601, ¶ 6:508) and the directors' right to inspect "all books, records and documents of every kind …" (Corps.C. § 1602, ¶ 6:500).

3) [6:509.1] **Common law inspection rights:** The lack of a *statutory* inspection right does not prevent shareholder inspection of corporate records and properties under appropriate circumstances. California courts recognize a common law inspection right wherever shareholders can show a "*proper and reasonable purpose*" related to their interests *as shareholders*. [See *Schnabel v. Sup.Ct. (Schnabel)* (1993) 5 C4th 704, 722-723, 21 CR2d 200, 211 (marital dissolution proceeding), *discussed further at* ¶ *4:381*]

"It would… be a strange rule which would allow the stockholder to examine the books of a corporation… and deny him an inspection of the property [or other records] to verify the statements contained in the books." [*Hobbs v. Tom Reed Gold Mining Co.* (1913) 164 C 497, 502, 129 P 781, 783]

4) [6:510] **Federal income tax returns accessible by 1% shareholder:** Under federal law, a person owning 1% or more of a corporation's outstanding stock may inspect the corporation's income tax return on file with the Internal Revenue Service. [IRC § 6103(e)(1)(D)(iii); see *Yorkshire v. I.R.S.* (9th Cir. 1994) 26 F3d 942, 946—1% shareholder of corporation filing as part of affiliated group may inspect group tax return]

5) [6:510.1] **Privacy rights of corporate personnel and other shareholders:** Personal financial information is within the zone of constitutionally-protected privacy rights (Cal. Const. Art. I, § 1). Thus, a shareholder's right of inspection may be qualified to the extent the records sought contain personal financial information relating to *third parties*. Privacy implications can be especially acute in closely-held corporations, which often possess confidential tax information about its shareholders.

Where a shareholder's asserted right of inspection runs up against a third-party privacy objection, courts must carefully *balance* the shareholder's need for the information (scope and purpose of the shareholder inquiry) against the threatened privacy infringement. [See *Schnabel v. Sup.Ct. (Schnabel)* (1993) 5 C4th 704, 718-723, 21 CR2d 200, 208-211—payroll tax information regarding majority shareholder/employee may be withheld from minority shareholder in marital dissolution proceeding (¶ *6:511*)]

(d) [6:511] **What purposes:** The burden is on the shareholder to show inspection is sought in connection with their interest *as a shareholder*, rather than for any unrelated or competitive interest. [See *Schnabel v. Sup.Ct. (Schnabel)* (1993) 5 C4th 704, 715-723, 21 CR2d 200, 206-211]

1) [6:512] **Examples:** A stated purpose to determine the *value* of the shares is generally sufficient. [See *Schnabel v. Sup.Ct. (Schnabel)* (1993) 5 C4th 704, 715, 21 CR2d 200, 206—in marriage dissolution property division proceeding, spouse had valid reason to determine value of shares in which community had an interest; *Homestake Mining Co. v. Sup.Ct.* (1936) 11 CA2d 488, 496, 54 P2d 535, 539]

Likewise, a stated purpose to determine whether to sell, or to invest further in the corporation is sufficient. [*Hartman v. Bandini Petroleum Co.* (1930) 107 CA 659, 661, 290 P 900, 901]

Compare: Under a comparable Delaware law allowing a shareholder to inspect corporate records "for any proper purpose," inspection to determine the reasonableness of compensation paid to the corporation's three top executives

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

was *not* a proper purpose absent some evidence of *possible mismanagement*. [*Seinfeld v. Verizon Communications, Inc.* (Del. 2006) 909 A2d 117, 125]

2) [6:513] **Comment:** Another legitimate purpose should be to assess the managerial performance of corporate officers and directors.

It is not clear whether a shareholder could claim inspection rights for other than financial reasons: e.g., in pursuit of social or political, as distinguished from financial, interests.

3) [6:514] **Impact of corporation having furnished audited statements:** Courts may be reluctant to compel shareholder inspection of corporate accounting records if the corporation has recently furnished audited financial statements. Some showing would probably have to be made to suggest that the audited statements were erroneous or incomplete.

(e) [6:515] **Mechanics of inspection:** Inspection may be conducted, at any reasonable time during usual business hours, by the shareholder in person, or through an agent or attorney. The right to inspect includes the right to make copies or extracts of any of the records. [Corps.C. § 1601(a), (b)]

1) [6:515.1] **Location:** The corporate books, records and minutes may be inspected at the corporation's *principal office in California*. If the corporation does not have a California office, the records must be made available at the office of the corporation's *registered agent for service of process in California* (*see* ¶ *4:23 ff., 3:416 ff.*). If the *original* records are not normally kept in California, or if they have been lost or destroyed, the shareholder may be given access to *copies* of the records. [Corps.C. § 1601(a)(1)]

Alternatively, the shareholder may request the corporation to produce the books, records and/or minutes by *mail* or *electronically* so long as the shareholder pays for the reasonable costs of *copying* the documents or *converting* them to electronic format. [Corps.C. § 1601(a)(2)]

Note: Section 1601(a) was amended (effective January 1, 2019) to overrule the decision in *Innes v. Diablo Controls, Inc.* (2016) 248 CA4th 139, 143-144, 203 CR3d 375, 377-378, which held that a California corporation that kept most of its records in Illinois need not make the records available for inspection in California. [See, e.g., Assembly Floor Analysis (6/15/18) of A.B. 2237; Senate Floor Analyses (6/7/18) of A.B. 2237]

(f) [6:516] **Enforcement by court action:** If necessary, a shareholder may file suit in the appropriate superior court to compel the corporation to allow them to inspect the requested records. Alternatively, "for good cause shown," the court may appoint an accountant to audit the books and records, and investigate the funds and affairs of the corporation; and report thereon as the court may direct. [Corps.C. § 1603(a)]

1) [6:517] **Expenses:** All expenses of the investigation or audit must be paid by the shareholder, unless the court orders them to be paid or shared by the corporation. [Corps.C. § 1603(c)]

If the court finds that the corporation's failure to permit inspection was "without justification," it may award the shareholder their expenses, including attorney fees. [Corps.C. § 1604; see *Jara v. Suprema Meats, Inc.* (2004) 121 CA4th 1238, 1263-1265, 18 CR3d 187, 206-208—attorney fees award improper where shareholder did not make proper inspection demand but instead requested corporation prepare and send to him monthly financial reports (¶ *6:508*)]

2) [6:518] **Statutory penalty:** If the action is filed within 90 days after written request and the shareholder can prove "damage" resulting from failure to obtain access to the corporation's accounting records, the court may also award a statutory penalty against the corporation: *$25 per day* beginning 30 days after the request was received, for as long as the failure continues, up to a maximum of $1,500 (and no more than $250 per day where numerous separate shareholder requests are made on the same day). [Corps.C. § 2200]

This penalty is *discretionary* with the court. It can refuse or limit the award if it finds the corporation's failure to permit inspection was "inadvertent or excusable." [Corps.C. § 2202]

(g) [6:519] **Validity of limitations:** The articles or bylaws of the corporation may enlarge, but *may not limit* the shareholders' right to inspect the corporate records. [Corps.C. § 1601(b)]

Nor may such rights be limited or waived in a close corporation shareholders agreement. [Corps.C. § 300(c); *see*¶ *3:256*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(3) [6:520] **Minutes of shareholders' or directors' meetings:** The shareholders' right to inspect minutes of shareholders' or directors' meetings is also limited by the requirement that a "purpose reasonably related to the [shareholder's] interests" be shown. [Corps.C. § 1601(a)]

Basically, the same rules and limitations apply as discussed above (¶ 6:506 ff.) in connection with inspection of other corporate records—including the ban on provisions in the articles or bylaws seeking to limit such right.

Additionally, management may deny inspection of sensitive portions of the minutes, such as those concerning personnel matters, reports by counsel reflecting privileged communications or, for public companies, material inside information not yet disclosed to the public (e.g., merger negotiations).

[6:521] ***Reserved.***

(4) [6:522] **List of shareholders:** Demands for inspection are far more common with respect to the list of shareholders. Reason: This is the normal way by which dissident shareholders seek to communicate their views to other shareholders. It follows that shareholder demands for access to the shareholders' list are often resisted by management, resulting in litigation to enforce the demand. (Management often insists that the shareholder seeking the list is acting for an improper purpose; e.g., to engage in competition with the corporation or to conduct a "fishing expedition.")

(a) Which shareholders entitled to inspect

1) [6:523] **Shareholders with 5% or more voting shares:** A shareholder (or group of shareholders) owning at least 5% of the corporation's outstanding voting shares has an *absolute, unconditional right* to inspect the list of shareholders. (No purpose or justification need be shown.) [Corps.C. § 1600(a)]

Moreover, if the corporation is required to file reports under the 1934 Act and the shareholders have filed a Schedule 14A (relating to proxy contests) with the Securities and Exchange Commission, the ownership requirement is reduced to *1%*. [Corps.C. § 1600(a)]

2) [6:524] **Shareholders with less than 5% voting shares:** Shareholders owning less than the required percentages are entitled to inspect the corporation's list of shareholders only if they show "a *purpose reasonably related* to such holder's interests as a shareholder …" [Corps.C. § 1600(c)]

a) [6:525] **Compare—Delaware law:** There is no California authority as to what constitutes a "proper purpose" for such inspection. However, stockholders of a Delaware corporation are entitled to inspect the corporation's stockholder list "for any proper purpose." Accordingly, decisions under Delaware's inspection statute should be instructive in determining a "purpose reasonably related" to a person's interest as a shareholder under Corps.C. § 1600(c).

Under Delaware law, a proper purpose includes a desire to solicit proxies for a slate of directors in opposition to management, the desire to investigate allegations of allegedly improper transactions or mismanagement, to communicate with other shareholders concerning the wisdom or fairness of a proposed recapitalization, and the need to evaluate the failure to pay dividends when combined with a request to value shares of the corporation. [See *General Time Corp. v. Talley Indus., Inc.* (Del. 1968) 240 A2d 755; and generally, E. Welch et al., *Folk on the Delaware General Corporation Law: Fundamentals*§ 220.05 (2019 Ed.)]

(b) [6:526] **Which corporations:** All California corporations and all out-of-state corporations having their principal offices here, or "customarily holding" board meetings here, must provide such inspection. [Corps.C. § 1600(d)]

1) [6:527] **Constitutionality upheld:** Applying California's statute to out-of-state corporations operating in California offends neither the commerce clause, due process nor equal protection. And, there is no objection under the full faith and credit clause (at least where the law of the incorporating state does not actually prohibit disclosing the shareholders' list to other shareholders). [*Valtz v. Penta Investment Corp.* (1983) 139 CA3d 803, 806-809, 188 CR 922, 924-926; and see *Sadler v. NCR Corp.* (2nd Cir. 1991) 928 F2d 48, 53-55—no commerce clause violation in subjecting Maryland corporation to New York law regarding shareholder lists]

(c) [6:528] **Mechanics of inspection:** First of all, the shareholder seeking inspection must make *written demand* upon the corporation at least *5 business days* before the shareholder list is to be produced. [Corps.C. § 1600(a)]

[6:529] If the list is maintained at the corporation's offices, access must be provided during usual business hours. If the list is maintained at a transfer agent, the corporation must cause such transfer agent to provide a copy of the list of

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

voting shareholders to the demanding shareholder upon payment of its usual charges for furnishing such information. [Corps.C. § 1600(a)]

[6:530] The inspection may be conducted by the shareholders personally, or through an agent or attorney. The right to "inspect" the shareholder list includes the right to copy same. [Corps.C. § 1600(a), (d)]

(d) [6:531] **Enforcement by court action:** If the corporation or transfer agent fails to comply with a proper demand for the list within the time limits aforesaid, the shareholder may sue to compel its production. [Corps.C. § 1600(b)]

1) [6:532] **Procedure:** The plaintiff-shareholder must file a *verified* complaint in the appropriate superior court. [Corps.C. § 1600(b)]

2) [6:533] **Order postponing meetings:** After notice to such persons as the court shall direct, the shareholder is *entitled* to an order postponing any pending shareholders' meeting. The postponement must be at least equal to the period of delay in furnishing them access to the shareholder list (thus affording the shareholder time to solicit proxies, etc.). [Corps.C. § 1600(b)]

3) [6:534] **Order for inspection:** The court may order the corporation to allow the shareholder to inspect and copy the list; or appoint some third party to conduct the inspection and make such report as the court directs. [Corps.C. § 1603(a)]

4) [6:535] **Expenses:** If the court finds that the corporation's failure to allow inspection was "without justification," it may award the shareholder their expenses, including attorneys' fees. An inspection denial is "without justification" when it is not "well grounded in both law and fact." [Corps.C. § 1604; *Farnum v. Iris Biotechnologies Inc.* (2022) 86 CA5th 602, 610-611, 302 CR3d 584, 590-591 (apparent case of first impression)]

Otherwise, the shareholder must pay all expenses incurred in connection with such inspection (although the court has power to order them shared by the corporation). [Corps.C. § 1603(c)]

[6:536] ***Reserved.***

5) [6:537] **Statutory penalty:** The same statutory penalty for failure to produce other corporate records (¶ *6:518*) applies for failure to produce the list of shareholders. [Corps.C. §§ 2200, 2202] (Remember that such penalty can be awarded only if legal action is commenced within 90 days after written demand for such inspection.)

(e) [6:538] **Validity of limitations:** As with other corporate records, the shareholders' inspection rights can be enlarged, but *may not be limited* by either the articles or bylaws. [Corps.C. § 1600(d)]

Nor may inspection rights be limited or waived in a close corporation's shareholders agreement. [Corps.C. § 300(c); *see*¶ *3:256*]

(f) [6:538.1] **Shares held in "street name"—duty to produce names of beneficial owners?** It is unclear whether, under California law, a corporation responding to a request for a shareholder list must produce the names and addresses of the underlying owners of shares held in a "street name"—i.e., shares held in the name of a brokerage firm for the convenience of its clients, the "beneficial owners." Corporations have the right under SEC Rule 14b-1(b)(3) to obtain the names and addresses of beneficial owners who do not object to disclosure of their identities ("nonobjecting beneficial owners," or NOBOs); however, they are not expressly required by California law to maintain a NOBO list (see Corps.C. § 1500, ¶ *6:497*). When confronted with a demand for a NOBO list, courts in other jurisdictions have generally required corporations to produce any NOBO list in their possession, but have divided on whether corporations must exercise their right under Rule 14b-1(b)(3) to obtain such a list solely for the benefit of requesting shareholders. [See, e.g., *Sadler v. NCR Corp.* (2nd Cir. 1991) 928 F2d 48, 52-53—corporation required to obtain NOBO list to allow maximum shareholder participation in proxy contest; *Cenergy Corp. v. Bryson Oil & Gas P.L.C.* (D NV 1987) 662 F.Supp. 1144, 1148—corporation need only produce NOBO list already in its possession; see also Rule 14b-1(b)(3) (17 CFR § 240.14b-1(b)(3))]

1) [6:538.2] **Comment:** "Street names" are of limited utility to shareholders requesting a shareholder list. While brokerage firms holding stock in "street name" must forward all proxies and proxy solicitations to the beneficial owners (see SEC Rule 14b-1(b)), requesting shareholders will have no way of contacting the beneficial owners directly. Also, the time lag inherent in the dissemination of proxy materials by brokerage firms and in obtaining a response from beneficial owners may pose problems when a shareholder needs to act quickly. [See Rule 14b-1(b) (17 CFR § 240.14b-1(b))]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[6:538.3 - 6:538.5] ***Reserved.***

(5) [6:538.6] **Communications with corporation's attorneys:** A corporation's confidential communications with its attorney are protected by the attorney-client privilege. [Ev.C. § 950 et seq.; *see*¶ *6:1.1*] In a shareholder's suit against the corporation, the shareholder's status as a shareholder does *not* give them the right to inspect privileged documents. Inspection is permitted only under *statutory exceptions* to the privilege—e.g., the "joint client" exception, where the shareholder has an independent attorney-client relationship with corporate counsel (Ev.C. § 962; *see*¶ *6:3.6 ff.*), or the "crime-fraud" exception where the attorney's services were sought to aid in the commission of a crime (Ev.C. § 956). [*National Football League Properties, Inc. v. Sup.Ct. (Oakland Raiders)* (1998) 65 CA4th 100, 107-111, 75 CR2d 893, 897-900—shareholder suing corporation for breach of contract, breach of fiduciary duty, negligence and mismanagement not entitled to discovery of privileged documents]

5. [6:539] **Reports:** Depending on its business activities, the corporation may be required to provide periodic tax returns, payroll information and other reports to various governmental agencies.

In addition, the Corporations Code requires every corporation to furnish the following reports and information:

a. [6:540] **Annual report to shareholders:** Every California corporation must provide an annual financial report to its shareholders as set forth below (¶ 6:541 ff.). (This also applies to foreign corporations having their principal offices in California or "customarily holding" board meetings here.) [Corps.C. § 1501(a)(1), (g); *see*¶ *4:213 ff.*]

The only *exception* is that corporations with *fewer than 100 shareholders* of record (as determined by Section 605) may adopt a *bylaw* expressly *waiving* the requirement of an annual report. [Corps.C. § 1501(a)(1); ¶ *4:389*] (Note, however, that the requirement of an annual report *cannot* be waived in a close corporation shareholders agreement; waiver must be in the *bylaws*. See Corps.C. § 300(c), ¶ *3:255*.)

[6:540.1] ***Caveat re SPCs:*** The paragraphs below (¶ 6:541 ff.) describe the annual report requirements applicable to corporations organized under the General Corporation Law (Corps.C. § 100 et seq.). SPCs (which are not organized under the General Corporation Law, ¶ 9:3) have their own annual report requirements. Moreover, it appears that SPC bylaws may *not* dispense with the annual report. *See discussion at ¶ 9:170 ff.*

(1) [6:541] **How provided:** The report may be sent by first- or third-class mail (*see* ¶ *6:542*). Alternatively, unless the articles or bylaws provide otherwise, the board of directors may authorize sending the report by electronic transmission (*see*¶ *4:199.8 ff.*). (But a corporation with an outstanding class of securities registered under § 12 of the 1934 Act need only make the report available on the Internet in accordance with SEC Rule 14a-16.) [Corps.C. § 1501(a)(1), (2), (4); see Rule 14a-16 (17 CFR § 240.14a-16)]

(2) [6:542] **When report due:** The report must be sent to the shareholders (or provided on the Internet when so permitted, ¶ *6:541*) at least 15 days before the annual shareholders' meeting (35 days, if sent by third-class mail); and in no event later than 120 days after the close of the fiscal year. [Corps.C. § 1501(a)(1), (2)]

Delays in furnishing the annual report do *not* justify delays in holding the annual shareholders' meeting; *see*¶ *6:52*.

(3) [6:543] **Contents of report:** The annual report to shareholders must contain at least:

• A balance sheet as of the close of the fiscal year;

• An income statement for the fiscal year; and

• A statement of cash flows for the fiscal year. [Corps.C. § 1501(a)(1)]

(a) [6:544] **Additional disclosures required for certain corporations:** Corporations with *at least 100* shareholders of record (as determined under Section 605), and not otherwise subject to the reporting requirements of the 1934 Act, must furnish certain additional information in their annual reports:

• [6:545] **Insider transactions:** Disclosure is required of any transaction (excluding compensation to officers and directors) involving more than *$40,000*, in which any officer, director or holder of more than 10% of its voting shares has a material, financial interest (direct or indirect). [Corps.C. § 1501(b)(1)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• [6:546] **Indemnification:** Likewise to be disclosed are the amounts and circumstances of any indemnification or advances for the benefit of any officer or director in excess of $10,000, that were not approved by the shareholders. [Corps.C. § 1501(b)(2)]

(b) [6:547] **Accounting standards:** Financial statements of corporations with 100 or more shareholders must be "prepared or determined in conformity with generally accepted accounting principles then applicable." (For example, such standards may require a corporation having subsidiaries to provide financial statements on a consolidated basis.) [Corps.C. § 114]

1) [6:548] **Compare—corporations with less than 100 shareholders:** The financial statements for corporations having fewer than 100 shareholders of record (as determined under Section 605) do *not* have to be prepared in conformity with generally accepted accounting principles … as long as they "reasonably set forth the assets and liabilities and the income and expense of the corporation and disclose the accounting basis used in their preparation." [Corps.C. § 1501(a)(3)]

(4) [6:549] **Certification:** The financial statements must be accompanied by a "report thereon of the independent accountants" who reviewed the statements. (This does *not* mean a certified audit, however. The "report" may simply state the sources from which the information was obtained, that no audit was done, and that no opinion is expressed as to the accuracy of the original entries.) [Corps.C. § 1501(a)(1)]

If there is no such report by independent accountants, there must be a certificate by an authorized officer of the corporation that the statements were prepared, without audit, from the books and records of the corporation. [Corps.C. § 1501(a)(1)]

(5) [6:550] **Annual report upon request:** If no annual report has been sent to the shareholders, it must be furnished upon the request of *any* shareholder. [Corps.C. § 1501(c)]

[6:551] The shareholder's request must be in writing, and made more than 120 days after the close of the fiscal year. The corporation must furnish the requisite financial statements within 30 days after receipt of such request; and copies made available to other shareholders demanding same. [Corps.C. § 1501(c)]

(6) [6:552] **Quarterly reports upon request:** In addition, shareholders with *5%* or more of *any class* of shares are entitled to obtain *interim* (quarterly) financial reports. [Corps.C. § 1501(c)]

[6:553] Upon written request, such shareholders are entitled to statements for the preceding 3-month, 6-month or 9-month period, plus a balance sheet as of the end of the most recent quarter (accompanied by the same sort of accountant's report or officer's certification as required for the annual report, ¶ 6:549). These interim reports are to be delivered or mailed to the shareholders requesting same within 30 days after such request. In addition, copies must be kept at the corporation's principal office and made available to any other shareholder requesting same. [Corps.C. § 1501(c), (d)]

(7) Enforcement by shareholder's suit

(a) [6:554] **Injunction:** A shareholder may sue in the appropriate superior court for an injunction to compel the corporation to prepare and furnish the requisite financial statements and information. (If the corporation shows a legitimate excuse, the court may extend the corporation's time to provide such information.) [Corps.C. § 1501(e)]

(b) [6:555] **Expenses:** In such suit, the court may award the shareholder their litigation expenses, including attorneys' fees, if it finds that the corporation's failure to comply was "without justification" (i.e., no reasonable excuse for denial). [Corps.C. § 1501(f)]

(c) [6:556] **Statutory penalty:** The court may also award a statutory penalty against the corporation for failure to furnish financial statements. The penalty is $25 per day beginning on the 30th day after receipt of written request for such statements. The maximum penalty is $1,500 (and no more than $250 per day where numerous shareholders make separate requests for the same report). [Corps.C. § 2200]

Such penalty is recoverable only if the shareholders file suit therefor *within 90 days* after making their request, and prove that they were *damaged* by the corporation's neglect or refusal to provide the report. [Corps.C. § 2200]

[6:556.1 - 6:556.4] ***Reserved.***

(8) [6:556.5] **Annual benefit report (benefit corporations):** A benefit corporation must deliver to its shareholders an annual *benefit* report in addition to or with the annual report. The benefit report must also be posted on any Internet website

maintained by the benefit corporation. If the corporation does not have an Internet website, the *most recent* benefit report must be provided without charge to *any person* requesting the report. (The annual benefit report *cannot be waived* by the shareholders.) [Corps.C. §§ 14621, 14630; *see detailed discussion at¶ 9:600 ff.*]

b. [6:557] **Annual information statement to Secretary of State:** Every corporation must update annually the statement of general information that is required to be on file with the Secretary of State: i.e., names and addresses of directors and principal officers; number of vacancies on board; principal business activity; address of principal office; and designation of agent for service of process. [See Corps.C. § 1502(a), (b); *¶ 4:474*]

(A supplemental disclosure form is required for publicly-traded corporations; *see¶ 4:479.6*.)

(1) [6:558] **Form and fee:** Several months in advance of the statement's due date, the Secretary of State will send the corporation a blank form by mail or, if the corporation provided an email address on its last statement, by email (but failure to receive the form does *not* excuse compliance). The form must be completed and returned (or filled in and filed online), along with a $20 fee, even if there have been no changes in the required information. (But a simplified filing on a form prescribed by the Secretary of State may be used where none of the pertinent information has changed.) [Corps.C. § 1502(a)(8), (c); Gov.C. § 12186(g)]

FORMS

• Statement of Information (California Stock, Agricultural Cooperative and Foreign Corporations) (SI-550)

• Corporate Disclosure Statement (SI-PT)

• Statement of No Change (SI-550 NC)

These forms may be filled in and filed online at the Secretary of State's website (*www.sos.ca.gov*).

(2) [6:559] **Purpose:** The purpose of the statement is to provide public access to certain essential information regarding every California corporation. But it does *not* place persons dealing with the corporation "on notice" of or under any duty to inquire about the information furnished or changes made. [Corps.C. § 1502(g)]

(3) Enforcement provisions

(a) [6:560] **Statutory penalty:** Failure to file the statement when due will result in assessment of a statutory penalty of $250, unless the corporation can show "reasonable cause or unusual circumstances" justifying such failure. [Corps.C. § 2204(a); Rev. & Tax.C. § 19141]

(b) [6:561] **Suspension:** After two years of not filing and imposition of penalties (¶ 6:560), the corporation is subject to suspension of its corporate powers, rights and privileges (*¶ 6:562 ff.*). [Corps.C. § 2205(a); see *Palm Valley Homeowners Ass'n, Inc. v. Design MTC* (2000) 85 CA4th 553, 559, 102 CR2d 350, 354]

(c) [6:561.1] **Reinstatement:** Notwithstanding its suspension, the corporation is empowered to file the overdue annual statement. Upon filing the statement and paying any fees or taxes that may be due, the suspension is lifted. [Corps.C. § 2205(d); see *Palm Valley Homeowners Ass'n, Inc. v. Design MTC* (2000) 85 CA4th 553, 559-560, 102 CR2d 350, 354]

[6:561.2 - 6:561.5] ***Reserved.***

c. [6:561.6] **Correction of false or misleading reports by publicly-held corporation:** A corporation that is either a 1934 Act reporting company or a company with a pending registration statement (*see¶ 5:54 ff.*) must notify its shareholders and the California Attorney General (or other "appropriate government agency," such as the Department of Financial Protection and Innovation or SEC) within *30 days* after discovering that any officer, director, manager or agent issued any materially false or misleading statement or report intended to affect the corporation's stock price. Failure to comply risks a civil penalty of up to $1,000,000, enforceable in an action by the Attorney General or a district or city attorney. [Corps.C. § 2207]

6. [6:562] **Suspension of Corporate Powers:** A California corporation's powers, rights and privileges may be suspended for:

• Failure to pay franchise taxes on time (Rev. & Tax.C. § 23301);

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Failure, under certain circumstances, to file the annual information statement required by Corps.C. § 1502 (¶ *6:557*) (Corps.C. § 2205(a));

• Failure to file a franchise tax return, even if no tax is due (Rev. & Tax.C. § 23301.5).

a. [6:563] **Effect of suspension:** During the period of such suspension, the only permissible corporate action is filing an application for tax-exempt status or amending the articles to perfect that application or to set forth a new corporate name. Otherwise, the corporation is disqualified from exercising any right, power or privilege. [Rev. & Tax.C. §§ 23301, 23301.5; see *Cal-Western Business Services, Inc. v. Corning Capital Group* (2013) 221 CA4th 304, 310, 163 CR3d 911, 915; *Timberline, Inc. v. Jaisinghani* (1997) 54 CA4th 1361, 1367, 64 CR2d 4, 7 (citing text)]

Indeed, any person who attempts or purports to exercise the powers, rights and privileges of a suspended corporation may be criminally punished by a $250 to $1,000 fine and/or up to one year in prison. (But this does not apply to an insurer or counsel retained by the insurer to defend the corporation in a civil action. *See* ¶ *6:564.11*.) [Rev. & Tax.C. § 19719(a), (b)]

(1) [6:564] **Incapacity to sue or defend in court:** Suspension of a corporation provides an opposing party with an affirmative defense that, when timely raised (*see* ¶ *6:564.1*), prevents the corporation from prosecuting or defending an action in a California court. [*Bourhis v. Lord* (2013) 56 C4th 320, 324, 153 CR3d 510, 512; *City of San Diego v. San Diegans for Open Gov't* (2016) 3 CA5th 568, 577, 207 CR3d 703, 709; *Cal-Western Business Services, Inc. v. Corning Capital Group* (2013) 221 CA4th 304, 310-312, 163 CR3d 911, 915-917—corporate assignee of claim acquired from suspended corporation likewise barred from bringing action to enforce claim during assignor's suspension]

Likewise, a suspended corporation may be prevented from:

— appealing an adverse judgment (*Tabarrejo v. Sup.Ct. (Princess Retirement Homes, Inc.)* (2014) 232 CA4th 849, 861-862, 182 CR3d 30, 42 (appeal of Labor Commissioner's order to superior court per Lab.C. § 98.2); *Kaufman & Broad Communities, Inc. v. Performance Plastering, Inc.* (2006) 136 CA4th 212, 222, 39 CR3d 33, 39; see *Bourhis v. Lord*, supra, 56 C4th at 323, 153 CR3d at 511—notice of appeal invalid when filed during corporation's suspension (but validated upon corporation's revivor, ¶ 6:572));

— petitioning for a writ of mandate (*Brown v. Sup.Ct. (Stewart)* (1996) 242 CA2d 519, 522, 51 CR 633, 635); or

— renewing a judgment obtained prior to suspension (*Timberline, Inc. v. Jaisinghani* (1997) 54 CA4th 1361, 1367, 64 CR2d 4, 7 (citing text)).

The corporation's incapacity to sue or defend in state courts may also preclude it from suing or defending in federal courts. [*Matter of Christian & Porter Aluminum Co.* (9th Cir. 1978) 584 F2d 326, 331]

(a) [6:564.1] **Waiver of incapacity defense by failure to timely assert:** A corporation's incapacity to sue or defend due to suspension must be raised by the opposing party *at the earliest opportunity*. Failure to do so *waives* the defense. [*V & P Trading Co., Inc. v. United Charter, LLC* (2012) 212 CA4th 126, 133, 151 CR3d 146, 151; *Color-Vue, Inc. v. Abrams* (1996) 44 CA4th 1599, 1603-1606, 52 CR2d 443, 446-447]

Thus, where plaintiff corporation's suspension existed at the time it *filed suit*, defendant must raise the incapacity defense in the *answer* (or by way of *demurrer* where the incapacity appears on the face of the complaint or is subject to judicial notice). [*V & P Trading Co., Inc. v. United Charter, LLC*, supra, 212 CA4th at 133-134, 151 CR3d at 150-151; see *Rossdale Group, LLC v. Walton* (2017) 12 CA5th 936, 943, 219 CR3d 605, 609-610; *and*¶ *6:564.3*]

Compare: Defendant's failure to timely raise plaintiff corporation's incapacity does not waive any *statute of limitations* defense that may *subsequently* arise from the incapacity; *see*¶ *6:564.6*.

1) [6:564.2] **Untimely assertion of defense in response to discovery motion:** Defendant's failure to timely assert the incapacity defense bars subsequent assertion of the defense in response to a motion by plaintiff corporation to compel discovery. A court's denial of the motion on incapacity grounds is thus *improper* and subject to reversal … as is any resulting *sanctions* award for *bringing* the motion. [*V & P Trading Co., Inc. v. United Charter, LLC* (2012) 212 CA4th 126, 136-137, 151 CR3d 146, 153-154]

2) [6:564.2a] **Exception where corporation refuses to pay delinquent taxes:** Where a corporation's suspension arises out of its failure to pay franchise taxes (*see*¶ *6:562*), the corporation's continued refusal to pay those taxes allows the trial court to grant the opposing party relief from its failure to timely raise the incapacity defense. To hold

otherwise would permit the suspended corporation to evade its state tax obligations while benefitting from the state court system. [*Cal-Western Business Services, Inc. v. Corning Capital Group* (2013) 221 CA4th 304, 312-313, 163 CR3d 911, 917-918 (corporation had been suspended more than 10 years and represented to court it had no intention of seeking revivor)]

3) [6:564.2b] **Standing to sue distinguished:***Capacity* to sue, which is the right to *come into court*, should not be confused with *standing* to sue, which is the right to *relief* in court. A corporation's suspension does not affect its *standing* to sue. [See *Rossdale Group, LLC v. Walton* (2017) 12 CA4th 936, 944-945, 219 CR3d 605, 611]

➪ [6:564.3] ***PRACTICE POINTER:*** Where plaintiff corporation's suspension existed at the time it filed suit but defendant failed to assert the incapacity defense in its answer, defendant may seek leave to amend the answer. But to succeed on the motion, defendant must make some showing justifying relief from the effect of the original waiver (e.g., defendant learned of the suspension only after filing the answer and promptly moved for leave to amend). [See *V & P Trading Co., Inc. v. United Charter, LLC* (2012) 212 CA4th 126, 134, 151 CR3d 146, 151, fn. 2]

(b) [6:564.4] **Corporate counsel's duty to notify court of suspension:** Notwithstanding counsel's duties (of confidentiality, etc.) to their client, an attorney who discovers that a corporate client is suspended and thus barred from prosecuting or defending a pending litigation matter has a duty to so advise the court. (The attorney's obligation to the *client* is to advise the client to seek reinstatement.) Failure to advise the court of the suspension is *unethical*, and evidence of *bad faith* that may support an award of *sanctions* against the client and/or the *attorney* for maintaining an unwarranted action (CCP § 128.5) and/or abusing the discovery process (CCP § 2023.010). [*City of San Diego v. San Diegans for Open Gov't* (2016) 3 CA5th 568, 578-580, 207 CR3d 703, 709-711; *Palm Valley Homeowners Ass'n, Inc. v. Design MTC* (2000) 85 CA4th 553, 562, 102 CR2d 350, 356]

(c) [6:564.5] **Service of process unaffected by suspension:** Service of process upon a suspended corporation is effected in the same manner as service upon a corporation that has not been suspended. Unless the corporation has formally *dissolved* or *forfeited its charter or right to do business* (CCP § 416.20), service remains governed by CCP § 416.10—i.e., a copy of the summons and complaint is delivered to (i) the corporation's designated agent for service of process (¶ *3:416, 4:477*), (ii) the president, chief executive officer or other head of the corporation, a vice president, a secretary or assistant secretary, a treasurer or assistant treasurer, a controller or chief financial officer, or a general manager, or (iii) in certain circumstances described by statute, the Secretary of State. [CCP § 416.10; *Gibble v. Car-Lene Research, Inc.* (1998) 67 CA4th 295, 301-313, 78 CR2d 892, 895-903]

(d) [6:564.6] **Statute of limitations runs during suspension:** A plaintiff with a claim against a suspended corporation must still file suit within the applicable statute of limitations. There is no statutory authority for "tolling" (extending) the limitations period during defendant's suspension. And because suspension does not impair plaintiff's ability to sue or serve a corporation with process (¶ 6:564.5), there is *no equitable reason* to toll the limitations period. [*Grell v. Laci Le Beau Corp.* (1999) 73 CA4th 1300, 1305-1306, 87 CR2d 358, 362-363]

Conversely, a suspended corporation with a claim against defendant must likewise file suit within the applicable statute of limitations. However, where a suspended corporation timely files suit but the limitations period expires during the course of the litigation, the corporation's subsequent revivor does *not* "reinstate" the claim. This is so even where defendant *waived* the incapacity defense by failure to timely assert it (¶ 6:564.1) … because the incapacity defense is *distinct* from the statute of limitations defense. [*V & P Trading Co., Inc. v. United Charter, LLC* (2012) 212 CA4th 126, 135-136, 151 CR3d 146, 152-153; *Casiopea Bovet, LLC v. Chiang* (2017) 12 CA5th 656, 664, 219 CR3d 157, 163; *City of San Diego v. San Diegans for Open Gov't* (2016) 3 CA5th 568, 579, 207 CR3d 703, 710; *see*¶ *6:572 ff.*]

(e) [6:564.7] **Court's jurisdiction to grant relief to adverse party not affected by corporation's suspension:** A suspended corporation's lack of capacity to sue or defend does not affect the court's jurisdiction to proceed in the matter and to grant relief to the adverse party. To hold otherwise would allow the corporation to benefit from the acts that led to its suspension. [See *Tabarrejo v. Sup.Ct. (Princess Retirement Homes, Inc.)* (2014) 232 CA4th 849, 868, 182 CR3d 30, 47]

• [6:564.8] As stated (¶ 6:564), a suspended corporation may be prevented from prosecuting an appeal, including appeal of a Labor Commissioner order to the superior court (Lab.C. § 98.2). Although the suspended corporation's filing of the notice of appeal is invalid, the court nevertheless has jurisdiction to accept the appeal and the mandatory bond (or cash deposit) posted in connection therewith (Lab.C. § 98.2(b)). Where the corporation chooses not to seek

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

reinstatement (¶ 6:568) and thus is prevented from prosecuting the appeal, the court may dismiss the appeal and order the bond forfeited to the adverse party (employee) as required by statute. [*Tabarrejo v. Sup.Ct. (Princess Retirement Homes, Inc.)*, supra, 232 CA4th at 863-868, 182 CR3d at 43-48]

[6:564.9 - 6:564.10] ***Reserved.***

(f) [6:564.11] **Limitation—intervention by insurer:** Where the corporation is unable to defend itself in court against a claim for which it is insured, the insurer may nevertheless *intervene* and defend against the claim. [*Reliance Ins. Co. v. Sup.Ct. (Wells)* (2000) 84 CA4th 383, 386-388, 100 CR2d 807, 809-811; see *Truck Ins. Exchange v. Sup.Ct. (Transco Syndicate #1)* (1997) 60 CA4th 342, 347-350, 70 CR2d 255, 258-260; and *El Escorial Owners' Ass'n v. DLC Plastering, Inc.* (2007) 154 CA4th 1337, 1349-1350, 65 CR3d 524, 534-535]

1) [6:564.12] **Reason:** If the corporation is barred from conducting a defense and the insurer is not permitted to intervene, the plaintiff will be able to obtain an unopposed default judgment, which it may then enforce (up to the amount of the policy limits) in a direct action against the insurer. [Ins.C. § 11580(b)(2)] This would punish the *insurer* for something it did not do and had no control over—i.e., the corporation's failure to pay taxes (or file an information statement or tax return, ¶ 6:562). [*Reliance Ins. Co. v. Sup.Ct. (Wells)* (2000) 84 CA4th 383, 386-388, 100 CR2d 807, 809-811; see *Truck Ins. Exchange v. Sup.Ct. (Transco Syndicate #1)* (1997) 60 CA4th 342, 347-348, 70 CR2d 255, 258—insurer could intervene in co-insurers' action against suspended corporation seeking to rescind co-insurers' policies (rescission would eliminate intervenor insurer's contribution rights)]

2) [6:564.13] **Distinguish—no subrogation by insurer:** An insurer may not assert a subrogation claim on behalf of a suspended corporation. A subrogated insurer "stands in the shoes of its insured"; it has no greater rights than the insured and is subject to the same defenses assertable against the insured. Hence, an insurer cannot do via subrogation what a suspended corporate insured cannot do on its own. [*Travelers Property Cas. Co. of America v. Engel Insulation, Inc.* (2018) 29 CA5th 830, 835-838, 240 CR3d 623, 626-629; see *Kaufman & Broad Communities, Inc. v. Performance Plastering, Inc.* (2006) 136 CA4th 212, 217-224, 39 CR3d 33, 35-42—Rev. & Tax.C. § 19719(b) exemption of insurer from criminal penalties (*see ¶ 6:563*) does not authorize insurer to defend in suspended corporation's name rather than intervene; see also *Truck Ins. Exchange v. Sup.Ct. (Transco Syndicate #1)* (1997) 60 CA4th 342, 349-350, 70 CR2d 255, 259]

(g) [6:565] **Compare—derivative suit against officers preventing reinstatement:** Although a suspended corporation cannot sue, one of its shareholders may maintain a derivative suit on its behalf against its officers who control the books, records or other *information needed to cure the suspension*. In such a case, it would be inequitable to allow the officers to assert the suspension as a shield against the derivative suit. [*Reed v. Norman* (1957) 48 C2d 338, 344, 309 P2d 809, 813]

(h) [6:565.1] **Compare—suit by third-party beneficiary of corporate contract:** A third-party beneficiary of a contract entered into by a corporation may bring suit to enforce the contract notwithstanding the corporation's suspended status at the time of suit. This is so even where the plaintiff beneficiary was also a shareholder and/or officer of the now suspended corporation and thus arguably bore some responsibility for the nonpayment of taxes or other events that led to the suspension. [*Bozzio v. EMI Group Ltd.* (9th Cir. 2016) 811 F3d 1144, 1149-1152—member of band whose corporation entered into Loan-Out Agreement with record company could bring suit against record company to enforce Agreement notwithstanding corporation's suspension at time of suit]

(i) [6:565.2] **Continuance to effect reinstatement:** Moreover, a suspended corporation is entitled to a "short continuance" so that it may effect reinstatement (e.g., by paying back taxes, *¶ 6:568*) and then resume prosecution or defense of the action. [*Cadle Co. v. World Wide Hospitality Furniture, Inc.* (2006) 144 CA4th 504, 511-513, 50 CR3d 480, 485-487; *Color-Vue, Inc. v. Abrams* (1996) 44 CA4th 1599, 1606, 52 CR2d 443, 447; *United States v. 2.61 Acres of Land* (9th Cir. 1986) 791 F2d 666, 668-670]

(2) [6:565.3] **Cannot engage in real estate transactions:** A suspended corporation may not "sell, transfer or exchange" real property within California. [Rev. & Tax.C. § 23302(d)]

(3) [6:566] **Contracts voidable:** Further, contracts entered into by the corporation during suspension are voidable at the option of the other party—but *not* at the option of the corporation. [Rev. & Tax.C. § 23304.1(a); see *Performance Plastering v. Richmond American Homes of Calif., Inc.* (2007) 153 CA4th 659, 669, 63 CR3d 537, 545]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [6:566.1] **Limitation—court-ordered rescission required:** The right to declare a contract voidable is exercisable only in a lawsuit brought by either party with respect to the contract. [Rev. & Tax.C. § 23304.5]

Upon finding the contract voidable, the court must order its rescission, *provided* the corporation (i) receives full restitution of any benefits it conferred under the contract, and (ii) was allowed a reasonable opportunity to "cure the voidability" (*see*¶ *6:572.1*). Absent a rescission order, the contract is enforceable. [Rev. & Tax.C. § 23304.5]

(b) [6:566.2] **Relief from voidability:***See*¶ *6:572.1 ff.*

(4) [6:566.3] **Cannot claim escheated property:** A suspended corporation cannot obtain from the California Controller property of the corporation that escheated under the Unclaimed Property Law (CCP § 1500 et seq.; *see* ¶ *6:597.5i ff.*). Nor can an *assignee or judgment creditor* of the corporation obtain the escheated property. This is so even where the judgment creditor acquired a judicial assignment (per CCP § 708.510) of the corporation's property or rights. An assignee who acquires a claim from a suspended corporation takes the claim *subject to any defenses that could be asserted against the corporation*, including *lack of capacity*. [*Casiopea Bovet, LLC v. Chiang* (2017) 12 CA5th 656, 663, 219 CR3d 157, 162]

(5) [6:566.4] **Potential loss of corporate name:** Among the rights lost by a suspended corporation is the right to hold a corporate name and prevent another corporation from adopting that name. Thus, another corporation may, by filing articles of incorporation (or a name reservation or amendment to its articles), effectively take away a suspended corporation's name and require it to adopt a new name prior to revivor. [*Boyer v. Jones* (2001) 88 CA4th 220, 224-225, 105 CR2d 824, 827; *see*¶ *3:408*]

(6) [6:567] **Potential administrative dissolution by Secretary of State where corporation suspended at least 60 months:***See*¶ 8:1179 ff.

b. [6:568] **Reinstatement (revivor):** A corporation that has been suspended for failure to pay franchise taxes or to file a franchise tax return may be reinstated by applying to the Franchise Tax Board, filing the necessary returns, and paying the overdue taxes plus any additions to tax, interest, penalties, and any other amounts due. When all payments due are made, the Franchise Tax Board issues a "certificate of revivor." [Rev. & Tax.C. § 23305]

If the suspension was for failure to file an annual information statement, the corporation can be reinstated simply by filing the statement. [Corps.C. § 2205(d)]

• ***FORM:*** The Franchise Tax Board's standard form Application for Certificate of Revivor—Corporation is available on the Franchise Tax Board's website (*www.ftb.ca.gov*).

(1) [6:568.1] **"Substantial compliance" rule:***Substantial compliance* with the revivor requirements permits corporations suspended for failure to pay franchise taxes or file returns (Rev. & Tax.C. §§ 23301, 23301.5) to nonetheless prosecute or defend actions prior to any official revivor. However, "substantial compliance" requires *payment in full* of all taxes, interest or penalties due the state. [See *Sade Shoe Co., Inc. v. Oschin & Snyder* (1990) 217 CA3d 1509, 1516, 266 CR 619, 624—corporation's payment of past-due tax only ($200), without payment of interest and penalties thereon ($90.85), not "substantial compliance" with Rev. & Tax.C. § 23305 revivor provisions]

(2) [6:569] **Who may reinstate:** Application for reinstatement may be made by a majority of the remaining directors, or by *any officer, stockholder or creditor* of the corporation, or any other interested person. Thus, for example, where some right or title is in the corporate name (or it is the plaintiff in pending litigation), any stockholder, creditor, or purchaser of the claim, title, or cause of action can arrange for its reinstatement to protect the corporation's rights therein. [Rev. & Tax.C. § 23305; see *Bozzio v. EMI Group Ltd.* (9th Cir. 2016) 811 F3d 1144, 1151, 1154]

(3) [6:570] **Clearance of corporate name:** Before a certificate of revivor is issued by the Franchise Tax Board, it must obtain from the Secretary of State an endorsement upon the revivor application that the corporate name is still available (*see* ¶ *6:566.4*). [Rev. & Tax.C. § 23305a]

(4) [6:571] **Conditional reinstatement:** Where the suspension is for nonpayment of franchise taxes, the Franchise Tax Board is authorized to allow partial payment of back taxes if it determines that revivor will improve its prospects for collecting the balance due. It may grant a certificate of revivor *conditioned* as to the time period or the functions that the revived corporation may perform, or both. [Rev. & Tax.C. § 23305b; see *Bozzio v. EMI Group Ltd.* (9th Cir. 2016) 811 F3d 1144, 1151, 1154]

(5) [6:572] **Effect of reinstatement:** A revivor has the effect of restoring all powers, rights and privileges to the suspended corporation. It also *validates* all acts and transactions that occurred while the corporation was suspended … *unless* a substantive defense (e.g., statute of limitations, ¶ *6:564.6*) accrued prior to the revivor. In other words, a corporate revivor

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

validates any *procedural* step taken on behalf of a corporation while under suspension (such as obtaining a judgment or attachment, bringing an appeal, undertaking discovery, or getting an extension of a land use permit). [Rev. & Tax.C. § 23305a; *Bourhis v. Lord* (2013) 56 C4th 320, 323, 153 CR3d 510, 511—notice of appeal filed during corporation's suspension validated by corporation's revivor even though revivor occurred after deadline for filing appeal; see *Longview Int'l, Inc. v. Stirling* (2019) 35 CA5th 985, 989-991, 247 CR3d 793, 795-797—recording of abstract of judgment during judgment creditor corporation's suspension validated by revivor and hence enforceable against real property owner; *Center for Self-Improvement & Comm. Develop. v. Lennar Corp.* (2009) 173 CA4th 1543, 1557, 94 CR3d 75, 84—Prop. 65 "toxic exposure" notice (Health & Saf.C. § 25249.6) given by suspended corporation validated by subsequent revivor; *Sea Breeze Salt, Inc. v. Mitsubishi Corp.* (9th Cir. 2018) 899 F3d 1064, 1075—dismissal of appeal "not required when a delinquent corporation pays its back taxes and the state restores its corporate powers while its appeal is pending"]

(a) [6:572a] **Rationale:** The suspension provisions are designed to put pressure on delinquent corporations to file their annual information statements and pay their taxes. That purpose is satisfied when the statement is filed and the taxes are paid. But the revivor does not "roll back the clock" and, thus, any rights that become barred during the suspension remain barred. [See *Peacock Hill Ass'n v. Peacock Lagoon Const. Co.* (1972) 8 C3d 369, 371, 105 CR 29, 30; *Benton v. County of Napa* (1991) 226 CA3d 1485, 1490-1491, 277 CR 541, 544-545; *ABA Recovery Services, Inc. v. Konold* (1988) 198 CA3d 720, 724-725, 244 CR 27, 30]

(b) [6:572.1] **Voidable contracts subject to "validation":** Suspended corporations may seek relief from the voidability of their contracts by:

- Filing an application for relief from contract voidability with the Franchise Tax Board (on a form provided by the Board);

- Designating the period for which relief is requested on the application (i.e., the period beginning on the same date as the corporation's income year and ending on the date the application is made);

- Filing any required tax returns, including returns for the relief period;

- Paying any tax, additions to tax, penalties, interest, and any other amounts owing, including any amounts attributable to the relief period; and

- Paying any daily penalty (¶ 6:572.2). [Rev. & Tax.C. § 23305.1(a)]

  Assuming the above conditions are satisfied, all contracts entered into during the relief period *that have not been rescinded by final court order* (*¶ 6:566.1*) are enforceable. [Rev. & Tax.C. § 23305.1(c)]

- The Franchise Tax Board's standard form Application for Relief from Contract Voidability is available on the Franchise Tax Board's website (*www.ftb.ca.gov*).

  1) [6:572.1a] **Relief from voidability need not be sought simultaneously with revivor:** Corporations that previously received revivor certificates (but did not simultaneously seek relief from voidability) have a second chance to correct their contractual voidability problems … so long as the contracts are ones for which relief from voidability *could have been granted* had the relief been sought simultaneously with restoring good standing. But relief from voidability must be sought for the *entire* period during which the corporation was suspended (and any applicable penalties must be paid; *see ¶ 6:572.2*). [Rev. & Tax.C. § 23305.1(b)(2)]

  2) [6:572.2] **Penalties:** Corporations are assessed a $100 penalty for each day for which relief from voidability is granted, but not exceeding *in total* the tax for the requested relief period. The penalty is due and payable on demand by the Franchise Tax Board. [Rev. & Tax.C. § 23305.1(b)(1)(B)]

c. [6:573] **Compare—forfeiture for failure to pay franchise taxes for five years:** If the corporation fails to pay franchise taxes for more than *five years*, the Attorney General has authority to sue to *dissolve* the corporation and forfeit its charter. [Corps.C. § 1801(a)(4); *see¶ 8:804*]

This is far more than a mere suspension of corporate powers. A judgment dissolving the corporation terminates its existence. There is no provision for reinstatement or revivor.

7. [6:574] **Share Transfers:** Corporate action may also be required in connection with a transfer of outstanding shares. The transfer must be entered on the corporation's share register, the old certificate cancelled and a new certificate issued (but, of course, these procedures differ if the corporation has adopted a system of *uncertificated* shares; *see*¶ 6:591.1 ff.).

More importantly, corporate action may be required to assure the transfer complies with federal securities laws, and to enable the transferor and transferee to obtain any required permit or consent to transfer from the Corporations Commissioner.

a. [6:575] **Restrictions on right to transfer:** Before any transfer can be effected, it is important to determine whether the shares are subject to any restrictions on transfer. Such restraints may arise from a variety of sources:

(1) [6:576] **Articles:** "Reasonable" restrictions on the right of the shareholders to transfer or hypothecate their shares may be included in the articles of incorporation. (If the restriction was added by amendment, it is not binding on shares already issued, unless the holder of such shares voted in favor of the amendment.) [Corps.C. § 204(b); see also Corps.C. § 2603(b) (SPCs) *and*¶ *4:131*]

(a) [6:576.1] **"Reasonableness" of restriction:***See*¶ *4:132*.

(2) [6:577] **Bylaws:** Alternatively, such restrictions may be set forth in the corporation's bylaws. [Corps.C. § 212(b)(1); *see*¶ *4:360*]

(3) [6:578] **Shareholder agreements:** Rights of first refusal or other restraints on transfer may be provided in a shareholders' buyout or similar agreement (*see* ¶ *3:188*). They are also common in the shareholders agreement of statutory close corporations (¶ 3:243).

(a) [6:579] **Enforcement:** If a restriction appears *only* in a shareholders agreement, the other shareholders may have to sue to *enjoin* a transfer in violation thereof. Otherwise, if the shares are transferred to an innocent purchaser, the corporation may be obliged to recognize the transferee as owner of the shares—notwithstanding violation of the restriction on transfer in the shareholders agreement.

(b) [6:580] **Comment:** For this reason, shareholder agreements commonly require that a legend be placed on each share certificate showing the existence of such restriction (*see*¶ *5:454*). (A special rule applies to shares in statutory close corporations, ¶ 6:581.)

(4) [6:581] **Close corporation share certificate:** To preserve close corporation status, share certificates issued by statutory close corporations *must* bear a *legend* warning of restrictions on transferability. [Corps.C. § 418(c), ¶ 3:241; see also Corps.C. § 2800(d) (SPCs, ¶ 9:62)]

By accepting such a share certificate, the holder (whether the original issuee or subsequent transferee) is deemed to: (i) waive any right to register such shares for sale to the public; and (ii) consent not to transfer the shares so as to increase the number of shareholders to more than 35. Any attempted voluntary inter vivos transfer which would increase the number of shareholders to more than 35 is void. [Corps.C. §§ 421, 418(d); see also Corps.C. § 2800(e) (SPCs)]

(5) [6:582] **Requirements of California Securities Law:** The Corporate Securities Law regulates share transfers in two ways:

(a) [6:582.1] **Transfers benefiting corporation treated as issuer transactions:** A transfer of outstanding shares is treated as an "issuer transaction" if *any portion* of the purchase price will be received directly or *indirectly* by the corporation that issued the securities. [Corps.C. § 25011]

Thus, the transfer will be subject to the same qualification requirements (and exemptions therefrom) as any offer or sale of a security by the corporation (*see*¶ *5:195 ff.*). [See Corps.C. § 25130]

1) [6:582.2] **Example:** S, a major shareholder in XYZ, Inc., sells one-half of his stock to B, with the understanding that B will loan additional funds to the corporation. The transfer benefits XYZ and must be qualified unless an exemption is available (the Corps.C. § 25102(f) exemption will be available in most cases; *see*¶ *5:256 ff.*).

2) [6:582.3] **Transfer of legended shares benefiting corporation:** If the shares are subject to a "legend condition" (¶ 6:582.4), the Commissioner's consent is not required for their transfer if the transaction would be exempt from qualification under Corps.C. § 25102(f). [Commr. Rule 260.141.11(b)(17)]

(b) [6:582.4] **Commissioner's consent required for other transfers:** The Financial Protection and Innovation Commissioner's consent is required *prior* to a sale or transfer of:

- Nonexempt "promotional" shares (i.e., shares issued for services in organizing the corporation). [See Commr. Rule 260.141.1; ¶ *5:329*]

• Shares that have been qualified with a legend imposed. [See Commr. Rule 260.141.10; ¶ *5:355*]

1) [6:582.5] **Procedure for obtaining consent to transfer:***See*¶ *6:586*.

2) [6:583] **Compare—certain transfers not requiring consent:** The Commissioner's consent is *not* required for certain transfers made to various specified classes of transferees deemed able to protect their own interests. These transferees include:

• The issuer (or a transfer benefiting the issuer, *see*¶ *6:582.3*);

• The transferor's ancestors, descendants or spouse (or any custodian or trustee for their account);

• Any other holders of the same class of securities; or

• Any person by gift (either inter vivos or on death). [Commr. Rule 260.141.11(b)(1), (4), (5), (6)]

(6) [6:584] **Requirements of federal securities laws:** Shares issued pursuant to the "private placement" or "limited offerings" exemptions from registration are "restricted" as to resale. The share certificates must bear an appropriate legend, and cannot be transferred until the shares are registered or a *separate exemption* from registration is established as to such resale. [SEC Rules 504 & 506 (17 CFR §§ 230.504, 230.506); *see* ¶ *5:123*]

(a) [6:585] **"Safe harbor" rules:** The SEC has adopted "safe harbor" rules for shares resold in the market after being held for a requisite period of time. In particular, "*nonaffiliates*" of the issuer who have held their securities for a minimum of *one year* may make unlimited resales without any restrictions. [See SEC Rule 144(b)(1)(ii), (d)(1)(ii) (17 CFR § 230.144(b)(1)(ii), (d)(1)(ii)); ¶ *5:125 ff.*]

(Comment: But this is of no help to shareholders of a closely-held corporation whose shares have no public market.)

b. [6:586] **Procedure for obtaining Financial Protection and Innovation Commissioner's consent:** Where the Financial Protection and Innovation Commissioner's consent is required for transfer ("promotional shares" or shares legended as a condition of qualification, *see* ¶ *6:582.4*), an application for such consent must be filed. This is the responsibility of the transferor and transferee, rather than the corporation; but often, counsel for the corporation is called upon to assist them in obtaining such consent.

(1) [6:587] **Application:** A special form of application must be used for this purpose. It must be accompanied by a "statement of transferee," by which the transferee acknowledges the restrictions on transfer and disclosure of "such information as necessary to make an independent evaluation of the fairness of the transaction." [See Commr. Rule 260.151(a), (b)]

FORMS

• The Commissioner's form, Application for Consent to Transfer Securities Pursuant to Section 25151 of the Corporate Securities Law of 1968, may be filled in and downloaded from the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

• The Commissioner's form, Statement of Transferee to Accompany Application for Consent to Transfer Securities Subject to Legend or Escrow Condition, may be filled in and downloaded from the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

(2) [6:587.1] **Filing fee:** There is a $20 filing fee for an Application for Consent to Transfer Securities. [Corps.C. § 25608(m)]

(3) [6:588] **Legend restricting further transfer:** Each new certificate must bear on its face the prescribed legend warning that any further transfer is unlawful without the Commissioner's consent. [Commr. Rule 260.141.11(c); *see*¶ *5:332, 5:355*]

(4) [6:589] **When qualification required—public offerings in nonissuer transactions:** There is usually no need to obtain a permit or to "qualify" a sale of shares already issued: Sales made by the holder for their personal account are exempt, as long as no public offering or advertising is involved. [Corps.C. § 25104(a)] (Other exemptions apply to involuntary sales; sales to institutional investors; certain transactions involving broker-dealers or underwriters, etc.; see Corps.C. § 25104(b)-(h).)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[6:590] On the other hand, if a large shareholder makes a *public offering* or distribution of their shares ("secondary distributions"), the transaction must be qualified unless the securities involved are exempt under the various provisions of Corps.C. §§ 25100 or 25101. [Corps.C. § 25130] (This prevents any "end run" around the qualification requirements—e.g., by a corporation issuing shares under § 25102(f) or some other exemption, to a shareholder who turns around and sells them to the public.)

(a) [6:590.1] **Qualification standards in nonissuer transactions:** The Commissioner of Financial Protection and Innovation has broad discretion to decide whether such nonissuer transactions should be subject to the same standards and rules as transactions by original issuers (*¶ 5:318 ff.*). [Commr. Rule 260.140.136]

However, the Commissioner's rules set forth specific circumstances under which such issuer-standards will ordinarily be applied. These include resales in connection with registered public offerings or Regulation A offerings, or where there is no significant existing market for the securities (i.e., there are no regular price quotations for the securities and they are held by fewer than 100 persons in California). [See Commr. Rule 260.140.136(a), (c)]

1) [6:590.2] **Nonqualifiable securities:** Securities that are under some voting or economic disadvantage, or are not freely transferable, ordinarily will *not* be qualified for nonissuer transactions. This includes nonvoting common shares, "restricted" stock or other securities subject to transfer restrictions under buy-out agreements, legend conditions, etc. [See Commr. Rule 260.140.138]

2) [6:590.3] **Issuer may not be a "shell" company:** An application to qualify securities for nonissuer transactions should show that the issuer's assets are productively employed in an *on-going* business (i.e., that the issuer is not merely a "shell" company). Ordinarily, annual gross revenues of at least $500,000 will satisfy this standard. [Commr. Rule 260.140.137]

(b) [6:590.4] **Exemption for Rule 144A resales:** To facilitate resales of "restricted" securities under SEC Rule 144A (resales to institutional investors, *¶ 5:131*), the Commissioner has exempted certain resales by purchasers in offerings effected under Corps.C. § 25102(f) ("limited offering" exemption), § 25102(i) (institutional and registered investors exemption) and § 25102(n) ("qualified purchasers" exemption). [See SEC Rule 144A (17 CFR § 230.144A)]

Thus, resales *complying with Rule 144A* are exempt from qualification, notwithstanding any prior representation by the purchasers that they were purchasing for their own account for investment purposes and not with a view to resale in connection with any distribution of the security. [Commr. Rule 260.102.10.1, 260.102.15, 260.102.18, 260.105.13.1]

c. [6:591] **Procedure for transfer by corporation:** From the corporation's standpoint, a transfer requires:

- Obtaining surrender of the existing certificate (properly endorsed by the shareholder or accompanied by separate assignment);
- Voiding the existing certificate (usually by marking it "VOID" and attaching it to its original stub in the book of share certificates);
- Issuing a new certificate to the transferee—including any *legend* or notice or statement affixed to the original certificate;
- Recording the transfer on the share register of the corporation (name and address of transferee; number and class of shares issued; see Corps.C. § 1500);
- Delivering the new certificate to the transferee;
- Where required by law, delivering to the transferee, at the same time as the certificate, a copy of the Financial Protection and Innovation Commissioner's rules restricting transfer (e.g., basically "promotional shares" or shares issued under qualification imposing a legend condition; see Commr. Rule 260.141.10, 260.141.11; *and¶ 6:586*).

FORMS

- Assignment of Shares Separate From Certificate, *see Form 6:N*.
- Transmittal Letter to Transferee Accompanying New Certificate, *see Form 6:O*.

(1) [6:591a] **Compare—share reacquisition by corporation:** A corporate reacquisition of outstanding shares is effective upon delivery of the shares to the corporation for surrender, *with or without* transfer endorsement on the certificates. [See *Simon v. Steelman* (1990) 224 CA3d 1002, 1006, 274 CR 218, 220]

(2) [6:591.1] **Compare—uncertificated shares:** If the corporation has adopted a system of share issuance, registration and transfer by electronic or other means not requiring the use of share certificates (*see*¶ 5:472 ff.), transfer is effected by delivery of a transfer *instruction* rather than an endorsed share certificate. [See Comm'l C. §§ 8102(a)(12), 8401(a)]

(a) [6:591.2] **Additional requirements for blockchain system:** California statutory authority allowing certain corporations to include provisions in their articles authorizing shareholder records to be kept by means of "blockchain technology" was repealed effective January 1, 2022. [See former Corps.C. §§ 204(a)(12), 2603(a)(12) (Stats. 2018, Ch. 889; repealed eff. 1/1/22)]

(b) [6:591.3] **Shares held by securities intermediary:** Where the shares are held by a securities intermediary, such as a brokerage firm or depositary (common for publicly-held corporations; *see ¶ 6:538.1*), the instruction frequently is given *orally* to a broker. [See Comm'l C. § 8102(a)(6)-(8), (14)]

The transfer is deemed effected when:

• The corporation registers the buyer as the registered owner; or

• Another person (other than a securities intermediary) either becomes the registered owner on behalf of the buyer or, having previously become the registered owner, acknowledges that it holds for the buyer. [See Comm'l C. § 8301(b)]

(3) [6:592] **Statutory penalty for failure to transfer shares:** The corporate officer responsible for transferring shares is subject to a statutory penalty if they "unreasonably" fail or refuse to do so; and so is any other officer or director who causes such failure or refusal. The penalty is $100, plus $10 per day for each day of delay in effecting the transfer, up to a maximum of $500. [Corps.C. § 2201]

(4) [6:592.1] **Immunity from liability for certain transfers:**Corps.C. § 420 immunizes the corporation, its transfer agent and registrar from liability for effecting certain securities transfers. This immunity is provided as follows:

• [6:592.2] **Joint tenants:** For transfers to a *surviving* joint tenant(s) of record, whether or not made with actual or constructive knowledge that the transfer breaches any agreement or trust between the joint tenants. [Corps.C. § 420(a)]

• [6:592.3] **Minors and incompetents:** For transfers *to or from* a minor or incompetent, or for recognizing or dealing with the minor or incompetent as a security holder, regardless of any notice of minority or incompetence (except written notice of the appointment of a guardian or conservator). [Corps.C. § 420(b)]

• [6:592.4] **Married persons:** For transfers *without the signature of the owner's spouse* (and regardless whether the corporate records indicate the securities are community property). [Corps.C. § 420(c)]

• [6:592.5] **Court orders:** For transfers pursuant to a court *order or judgment* that has been *modified, set aside, or reversed* … unless prior to completing the transfer, the corporation or its transfer agent has been served—in the same manner as required for service of summons in a civil action—with written notice that an appeal or other further court proceeding has been or will be taken. (After service of such notice, neither the corporation nor its transfer agent need register the transfer until receiving a certificate from the county clerk showing the judgment or order has become final.) [Corps.C. § 420(d)]

(a) [6:592.6] **Immunity not affected by other Code provisions:** The immunity created by Corps.C. § 420 overrides any provision to the contrary contained in Family Code § 1100 or the Commercial Code. [Corps.C. § 420(e)]

d. [6:593] **Effect of transfer of unpaid shares:** If the shares were only partly paid for when issued (i.e., an unpaid balance owing on the subscription), the share certificate (or "initial transaction statement," *¶ 5:474*) will normally bear a legend or notice as to the amount owing. As long as it does, any transferee (even a purchaser for value) becomes personally liable to the corporation or its creditors (along with the transferor) for the amount so shown. [See Corps.C. §§ 410-412; *¶ 3:321*]

However, if the share certificate (or "initial transaction statement") *fails* to disclose an unpaid subscription balance, and the transferee had no knowledge thereof, they are not personally liable to the corporation or its creditors. [See Corps.C. § 411; *¶ 3:324*]

[6:594] ***Reserved.***

e. [6:595] **Transfers affecting corporate status:** Certain transfers of shares may affect the status of the corporation itself:

• [6:596] Transfers that increase the number of shareholders to more than 35 automatically terminate the corporation's status as a *statutory close corporation*. [Corps.C. § 158(e); ¶ 3:242]

• [6:597] Transfers that increase the number of shareholders to more than 100 (or a transfer to a corporation or partnership or nonresident alien) automatically disqualify the corporation from electing to be taxed as an *"S corporation."* [IRC § 1361(b)(1); *¶ 2:154*]

f. [6:597a] **Transfers triggering corporate realty reassessment and potential transfer tax:** Transfers of shares representing cumulatively more than half of the total stock of a corporation result in a "change in ownership" of any California real estate owned *by the corporation*. Consequently, the property is subject to *reassessment* for property tax purposes (and might also be subject to payment of a *documentary transfer tax*). [Cal. Const. Art. XIIIA, § 2; Rev. & Tax.C. §§ 64(c), (d), 11911, 25105; *see ¶ 2:177.8 ff.*]

[6:597b - 6:597e] ***Reserved.***

8. [6:597f] **Corporation's Punitive Damages Liability for Employee's Acts:** Under the doctrine of "respondeat superior," a corporation, like any other employer, may be liable for negligent or intentional injuries committed by an employee acting within the course and scope of employment. [See generally, *Hinman v. Westinghouse Elec. Co.* (1970) 2 C3d 956, 959-960, 88 CR 188, 190]

However, a corporate employer is *not* liable for *punitive* damages based on an employee's acts *unless* an *officer, director or* "*managing agent*":

• Had *advance knowledge* of the employee's *unfitness* and employed them with a *conscious disregard* of the rights or safety of others; *or*

• *Authorized or ratified* (*¶ 6:597h*) the employee's oppressive, fraudulent or malicious conduct; *or*

• Was personally guilty of *oppression, fraud or malice*. [Civ.C. § 3294(a), (b)]

a. [6:597g] **"Managing agent":** For purposes of Civ.C. § 3294, "managing agent" status does not necessarily turn on a person's position in the corporate hierarchy or whether they have authority to hire or fire employees. Rather, the question is whether the person exercises *substantial independent authority and judgment over decisions that ultimately determine corporate policy*. Stated otherwise, plaintiff must show the person "exercised *substantial discretionary authority* over *significant aspects of a corporation's business*." [*White v. Ultramar, Inc.* (1999) 21 C4th 563, 573-577, 88 CR2d 19, 26-29 (emphasis added)]

b. [6:597h] **"Ratification":** "Ratification" within the meaning of Civ.C. § 3294 requires proof the corporate officer, director or managing agent *actually knew* of the employee's *wrongdoing and its outrageous nature*. [*College Hosp., Inc. v. Sup.Ct. (Crowell)* (1994) 8 C4th 704, 725-726, 34 CR2d 898, 911-912]

"Ratification" generally occurs where the employer demonstrates an intent to *adopt or approve* the employee's oppressive, fraudulent or malicious behavior in the performance of their job duties. Ratification may also occur where the employer *fails to intercede* in a known pattern of workplace abuse, or *fails to investigate or discipline* the errant employee once such misconduct becomes known. [*College Hosp., Inc. v. Sup.Ct. (Crowell)*, supra]

Cross-refer: For a detailed treatment of a corporation's respondeat superior and punitive damages liability, see Haning, Flahavan, Cheng & Wright, *Cal. Prac. Guide: Personal Injury* (TRG), Chs. 2 and 3.

9. [6:597.1] **CERCLA Liability:** Pursuant to the Comprehensive Environmental Response, Compensation & Liability Act of 1980 (CERCLA, 42 USC § 9601 et seq.), *owners or operators* of any facility at which hazardous substances have been disposed of are liable for clean-up costs and/or damages for injury or loss to natural resources resulting from the release of such substances. [See 42 USC § 9607]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cross-refer: The following overviews selected CERCLA provisions of interest to corporate practitioners. For a more detailed discussion of CERCLA, see Greenwald & Bank, *Cal. Prac. Guide: Real Property Transactions* (TRG), Ch. 5.

a. [6:597.1a] **Individual liability for corporation's violations:** An "operator" for CERCLA purposes is one who directs the workings of, manages or conducts the affairs of a contaminating facility. It is not enough that the alleged operator have the authority to control the facility; the operator must manage, direct or conduct operations *specifically related to pollution*. [*United States v. Bestfoods* (1998) 524 US 51, 66-67, 118 S.Ct. 1876, 1887]

Thus, directors, officers and shareholders can be held personally responsible under CERCLA for the corporate entity's hazardous release or disposal only on (1) a *direct* liability theory as an "operator" where the particular director, officer or shareholder *actively participated in the day-to-day management of the polluting facility*, or (2) an *indirect* (*derivative*) liability theory where abuse of the corporate form (or a fraud) warrants *piercing the corporate veil*. [*United States v. Bestfoods*, supra, 524 US at 62, 118 S.Ct. at 1885; *Browning-Ferris Indus. of Ill., Inc. v. Ter Maat* (7th Cir. 1999) 195 F3d 953, 955-956]

(1) [6:597.1b] **Corporate indemnification:** A corporation may indemnify an officer or director (or other person) found liable under CERCLA as an "owner or operator." Indemnification is permitted even though the individual's liability is "not derivative but personal." [*United States v. Lowe* (5th Cir. 1994) 29 F3d 1005, 1009 (remanded to determine whether individual's CERCLA liability arose from his status as officer/director); see *Bowen Engineering v. Estate of Reeve* (D NJ 1992) 799 F.Supp. 467, 483-489, aff'd (3rd Cir. 1994) 19 F3d 642]

b. [6:597.2] **Parent's liability for subsidiary's violations:** The Supreme Court, resolving a split among the circuits, held that a parent corporation may have *derivative* liability for its *subsidiary's* CERCLA violations only in circumstances that allow the corporate veil to be pierced. Otherwise, a parent may be liable only under a *direct* liability theory as a facility "*operator*"—i.e., where it actively participates in and exercises control over the operations of the polluting facility. [*United States v. Bestfoods* (1998) 524 US 51, 62-67, 118 S.Ct. 1876, 1885-1887 (rejecting cases holding that parent's control over subsidiary can result in derivative CERCLA liability without piercing corporate veil); see *Atlantic Richfield Co. v. Central Valley Regional Water Quality Control Bd.* (2019) 41 CA5th 91, 96-100, 253 CR3d 888, 892-895]

(1) [6:597.3] **Veil piercing governed by state or federal law?** The Supreme Court left open the question whether, in enforcing derivative CERCLA liability, courts should borrow state law or instead apply a federal common law of veil-piercing. [*United States v. Bestfoods* (1998) 524 US 51, 63, 118 S.Ct. 1876, 1885, fn. 9]

The federal circuits are split on whether state law or federal common law governs derivative CERCLA liability. [See *United States v. General Battery Corp., Inc.* (3rd Cir. 2005) 423 F3d 294, 298-305 (applying federal common law); compare *Marsh v. Rosenbloom* (2nd Cir. 2007) 499 F3d 165, 181-184 (applying state law); *United States v. Davis* (1st Cir. 2001) 261 F3d 1, 53-54 (same)]

[6:597.4] *Reserved.*

c. [6:597.5] **Successor liability:** Corporations may also be liable for their predecessors' CERCLA violations under traditional *successor liability* rules developed by most state courts. [See *Atchison, Topeka & Santa Fe Ry. Co. v. Brown & Bryant, Inc.* (9th Cir. 1998) 159 F3d 358, 361-362; *Henkel Corp. v. Hartford Accident & Indemnity Co.* (2003) 29 C4th 934, 942-943, 129 CR2d 828, 834 (overruled on other grounds by *Fluor Corp. v. Sup.Ct.* (*Hartford Accident & Indemnity Co.*) (2015) 61 C4th 1175, 1218-1224, 191 CR3d 498, 531-536)]

Under these traditional rules, successor liability is imposed where:

- The transaction is a merger or "de facto" merger (¶ *8:275.1*);

- The acquirer expressly or impliedly agrees to assume liability;

- The acquirer is simply a continuation of the selling corporation (see *United States v. Carolina Transformer Co.*, supra; *Oner II, Inc. v. United States Environmental Protection Agency* (9th Cir. 1979) 597 F2d 184, 186; *and*¶ *8:656 ff.*); or

- The transaction is entered into fraudulently to escape liability. [See *Atchison, Topeka & Santa Fe Ry. Co. v. Brown & Bryant, Inc.*, supra, 159 F3d at 361, 365; compare *Quemetco Inc. v. Pacific Automobile Ins. Co.* (1994) 24 CA4th 494,

501, 29 CR2d 627, 631—successor corporation not covered under predecessor's insurance for CERCLA violations arising after acquisition]

(Under certain circumstances, "successor liability" is also applied to *product liability claims*; *see¶ 8:663 ff.*)

[6:597.5a - 6:597.5d] ***Reserved.***

d. [6:597.5e] **No CERCLA preemption of state limitations period for suits against dissolved corporation:** The capacity of a corporation to sue or be sued is determined by the law under which it was organized (FRCP 17(b)). The CERCLA statute of limitations (42 USC § 9613(g)—generally, three years after discovery of the loss) does *not* preempt state statutory provisions prescribing the time within which a dissolved corporation retains its capacity to be sued. [*Louisiana-Pacific Corp. v. ASARCO, Inc.* (9th Cir. 1993) 5 F3d 431, 432 (applying Washington law); compare *United States v. SCA Services of Indiana, Inc.* (ND IN 1993) 837 F.Supp. 946, 952-953—corporation that did not properly follow state law dissolution procedure could not escape CERCLA liability; *and see¶ 8:998 ff.* for discussion of postdissolution lawsuits against corporation]

[6:597.5f - 6:597.5h] ***Reserved.***

10. [6:597.5i] **Delivery to State (Escheat) of Unclaimed Corporate Shares, Bonds and Distributions:** Under the Unclaimed Property Law (CCP § 1500 et seq.), any dividend or other distribution to certain shareholders or bondholders (¶ 6:597.5j) who have not claimed the distribution, or corresponded in writing with the corporation concerning the distribution, within *three years* after the payment date, *escheats* to the State of California. Similarly, the stock of a shareholder who has not claimed a dividend or distribution, or has not corresponded in writing with the corporation or otherwise communicated as a shareholder "as evidenced by a memorandum or other record on file" with the corporation, *escheats* to California if the corporation does not know the shareholder's location at the end of the three-year period. [CCP § 1516(a)-(c); see *Vanacore & Assocs., Inc. v. Rosenfeld* (2016) 246 CA4th 438, 446, 201 CR3d 97, 103]

Caveat—don't wait three years: Although the statute specifies escheat after three years, the corporation is required to send the shareholder or bondholder a notice six-to-12 months before the escheat (*¶ 6:597.5k*). As a practical matter, therefore, once property has been unclaimed for *18* months or more, the corporation must begin to keep track of it so it can send the shareholder or bondholder the requisite notice.

a. [6:597.5j] **Applicable primarily to California shareholders/bondholders:** The corporation's duty to transfer unclaimed shareholder or bondholder property to California applies with respect to shareholders or bondholders:

• Whose last known address *as shown in the corporation's records* is in California; or

• Having no address *as shown in the corporation's records* but whose last known address is in California; or

• Whose last known address *as shown in the corporation's records* is in a state that does *not* provide for the escheat of unclaimed corporate shares or distributions; or

• Whose last known address *as shown in the corporation's records* is in a foreign nation. [CCP § 1510]

b. [6:597.5k] **Notice to shareholder/bondholder prior to escheat:** If the corporate records show an address for the shareholder or bondholder, which the records do not disclose to be inaccurate, the corporation must make *reasonable efforts* to notify the shareholder or bondholder by mail or, if the shareholder or bondholder has consented to electronic notice, electronically, not less than six nor more than 12 months before the time the property becomes reportable to the California Controller (¶ 6:597.5***l***). The notice must inform the shareholder or bondholder of the looming escheat and contain other specified disclosures set forth by statute. [CCP § 1516(d); see *Vanacore & Assocs., Inc. v. Rosenfeld* (2016) 246 CA4th 438, 446, 201 CR3d 97, 103]

c. [6:597.5***l***] **Report and payment to California Controller:** A corporate officer must file a report of property to be escheated on a form prescribed by the California Controller before November 1 containing the requisite information stated as of the immediately preceding June 30 or fiscal year end. The property to be escheated is then paid to the Controller between seven months and seven months and 15 days after the due date of the report; but if, during that time, the property owner establishes their right to receive the property, the corporation must, instead of paying the property to the Controller, file a report with the

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Controller containing specified information regarding the property. [CCP §§ 1530, 1532(a), (b), (e); see *Vanacore & Assocs., Inc. v. Rosenfeld* (2016) 246 CA4th 438, 447, 449, 201 CR3d 97, 104, 106]

(1) [6:597.5m] **Stock transfer:** In the case of escheated stock (¶ 6:597.5i), the corporation must either deliver a duplicate share certificate to the California Controller or register the shares in uncertificated form in the name of the California Controller, who may then sell it. [CCP §§ 1532(d), 1560(a), 1563; see *Vanacore & Assocs., Inc. v. Rosenfeld* (2016) 246 CA4th 438, 447, 201 CR3d 97, 104]

(a) [6:597.5n] **Immunity from liability:** Upon delivery of the duplicate certificate or evidence of transfer of the shares in uncertificated form to the California Controller, a corporation that complied with all the escheat requirements (property properly escheatable, notice to shareholder, etc.) is immune from all liability to any person for any loss arising from the escheat. [CCP § 1532(d); *Azure Ltd. v. I-Flow Corp.* (2009) 46 C4th 1323, 1327, 96 CR3d 501, 502]

11. [6:597.6] **California Corporate Criminal Liability Act of 1989:** Corporations and corporate managers may be charged with a misdemeanor or felony for *knowingly* failing to disclose "serious concealed dangers" (subject to government regulation) associated with a product (or component) or a business practice of which they have *actual knowledge*. [Pen.C. § 387]

a. [6:597.7] **Disclosure requirements:** Within 15 days of acquiring actual knowledge of a "serious concealed danger" (or immediately, if there is imminent risk of death or great bodily harm), the corporation or manager must give written notice of the hazard to Cal-OSHA and all affected employees. [Pen.C. § 387(a)(2)]

(Cal-OSHA has 24 hours thereafter to notify the appropriate regulatory agency, if other than itself; Pen.C. § 387(a)(2)(A).)

(1) [6:597.8] **Exception:** Disclosure is not required if the hazard is abated within the above time limits (¶ 6:597.7) … unless otherwise required by regulation of the appropriate government agency. [Pen.C. § 387(a)(2)(B)]

(2) [6:597.9] **Use of notice in subsequent criminal actions:** Notice of a "serious concealed danger" may not be used against a corporate manager in *any* criminal case, except prosecutions for perjury or for giving false statements. [Pen.C. § 387(c)]

b. [6:597.10] **Penalties:** Violation of § 387 is punishable by imprisonment in county jail for up to one year and/or a maximum $10,000 fine; or by imprisonment in state prison for 16 months, two or three years and/or a maximum $25,000 fine. If the defendant is a corporation, a maximum $1,000,000 fine may be imposed. [Pen.C. § 387(a)]

[6:597.11 - 6:597.19] *Reserved.*

12. [6:597.20] **Ratification and Judicial Validation of Noncompliant Corporate Actions:** Subject to certain limitations (¶ 6:597.60 ff.), the Code permits the ratification (¶ 6:597.21 ff.) or judicial validation (¶ 6:597.40 ff.) of an *otherwise lawful* "corporate action" that is not in compliance (or purportedly not in compliance) with the General Corporation Law or the corporation's articles, bylaws, or a plan or agreement to which the corporation is a party. Except as a court otherwise determines, such a ratification or validation is conclusive, absent fraud. [Corps.C. § 119; see Corps.C. § 119(a)(1), (2)]

Actions that may be ratified or validated include board or shareholder actions and any other action taken by or on behalf of the corporation (including the issuance of securities). [Corps.C. § 119(h)(1), (3)(defining "securities")]

Section 119 does *not* limit the use of any other lawful means to ratify or validate a corporate action or to correct a record. [Corps.C. § 119(a)(3)]

a. Ratification by corporation

(1) [6:597.21] **Approval:** A ratification (other than one relating to the election of the initial directors; *see*¶ 6:597.24) must be approved by the board, and, as applicable, by the shareholders "in accordance with any provision … applicable to the type of corporate action proposed to be ratified and in effect *at the time of the ratification*." However, if a "higher approval standard" (as defined) was applicable *at the time the original action was taken,* that higher approval standard applies. [Corps.C. § 119(b)(1)(A) (emphasis added); see also Corps.C. § 119(h)(2) (defining "higher approval standard")]

Only the board must approve a ratification if there are "no shares outstanding and entitled to vote on the ratification at the time of the ratification." [Corps.C. § 119(b)(1)(A)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [6:597.22] **Resolutions for actions not related to election of initial directors:** To approve a ratification *other than* one related to the election of the initial directors (*see*¶ 6:597.24), the board (and, as applicable, the shareholders; *¶ 6:597.21*) must adopt resolutions setting forth *all* of the following:

• each corporate action to be ratified (Corps.C. § 119(b)(1)(A)(i));

• the date each action was purportedly taken and its effective date (if different than the purported action date) (Corps.C. § 119(b)(1)(A)(ii));

• for a corporate action involving purported share issuance, the *number* and *type* of shares purportedly issued and the *date(s)* upon which they were purportedly issued (Corps.C. § 119(b)(1)(A)(iii));

• the nature of the noncompliance or purported noncompliance of each action (Corps.C. § 119(b)(1)(A)(iv)); *and*

• a statement that the ratification of each action is approved (Corps.C. § 119(b)(1)(A)(v)).

(a) [6:597.23] ***Caution—corporate actions re share issuance:*** The votes of any shares issued or purportedly issued pursuant to an action being ratified *must be disregarded* for all purposes of the ratification's approval (including, but not limited to, determining a quorum at a shareholder meeting or required class vote). [Corps.C. § 119(b)(1)(B)]

(3) [6:597.24] **Resolutions for actions related to election of initial directors:** To approve a ratification related to the election of the initial directors pursuant to Corps.C. § 210, the majority of persons who are exercising the powers of a director *at the time of the ratification* may approve the ratification by adopting resolutions setting forth *all* of the following:

• the names of the persons who first took actions in the corporation's name as the corporation's initial directors (Corps.C. § 119(b)(2)(A));

• the *earlier* of (a) the date on which those persons first took such action or were purported to have been elected as the initial directors and (b) the date on which those persons are deemed to have become the initial directors, if different than the date of the first action or purported election, as applicable (Corps.C. § 119(b)(2)(B)); *and*

• that the ratification of the election of such person(s) as the initial directors is approved (Corps.C. § 119(b)(2)(C)).

(4) [6:597.25] **Notice of ratification:** Notice of any ratification must be given "promptly" after ratification to each shareholder and holder of shares purportedly issued at the time of ratification, regardless of whether their approval is required for ratification. [Corps.C. § 119(c)]

The notice must be given as provided in Corps.C. § 601(b) (¶ 6:76 ff.) and must include a copy of any resolutions adopted pursuant to the ratification process (¶ 6:597.24). [Corps.C. § 119(c)]

Where a corporation that is subject to SEA §§ 13 or 15(d) reporting requirements includes the required disclosures in a report, proxy statement, or information statement filed with or furnished to the SEC, notice is deemed given when the report or statement is filed with or furnished to the SEC. [Corps.C. § 119(c)]

(5) [6:597.26] **Certificate of ratification:** Where a ratified corporate action would have required a filing with the Secretary of State, or the ratification would cause any instrument previously filed with the Secretary of State to be materially inaccurate or incomplete after giving effect to the ratification, the corporation must file a certificate of ratification with the Secretary of State to make, amend, or correct each instrument. [Corps.C. § 119(d)(1)]

(a) [6:597.27] **Contents:** The certificate of ratification must consist of an "officers' certificate" setting forth *all* of the following:

• the corporation's name and Secretary of State file number (Corps.C. § 119(d)(1)(A));

• the title of each instrument being made, amended, or corrected (Corps.C. § 119(d)(1)(B));

• the date each instrument was filed with the Secretary of State (or a statement that it was not previously filed) *and*, as applicable, a statement that the approved ratification would cause the instrument to be inaccurate or incomplete in any material respect after giving effect to the ratification (Corps.C. § 119(d)(1)(C));

• the date the instrument shall be deemed effective (which may be before or after the filing date) (Corps.C. § 119(d)(1)(D));

• a statement that the certificate of ratification is making, amending, or correcting the instrument, and a copy of the instrument containing all the required information (Corps.C. § 119(d)(1)(E));

• a statement that the ratification has been approved, together with a copy of the resolutions adopted, including, in the case of the ratification of any corporate action involving purported share issuance, the number and type of shares, the date(s) upon which they were purportedly issued, and, if applicable, a statement of the total number of outstanding shares of each class entitled to vote with respect to the ratification (Corps.C. § 119(d)(1)(F)); *and*

• a statement that the number of shares of each class voting in favor of the ratification equaled or exceeded the required vote, specifying the percentage vote required for each class entitled to vote (Corps.C. § 119(d)(1)(G)).

(b) [6:597.28] **Filing or refusal to file by Secretary of State:** The certificate of ratification must be filed with the Secretary of State. [Corps.C. § 119(d)(1)]

However, the Secretary of State's office may, in its discretion, refuse to file the certificate if the instrument would render prior filings inaccurate, ambiguous, or unintelligible. Upon such refusal, the corporation must seek judicial validation pursuant to Corps.C. § 119(e) (¶ 6:597.40 ff.). [Corps.C. § 119(d)(2)]

[6:597.29 - 6:597.39] ***Reserved.***

b. [6:597.40] **Judicial validation:** The filing of a petition by an "authorized person" *(¶ 6:597.41)* in the "proper county" *(¶ 6:597.42)* vests the superior court with *equitable jurisdiction* to (1) determine the validity of any corporate action (whether or not it has been ratified or the subject of ratification) or corporate security; (2) validate and declare effective the corporate action or security; and (3) declare the effective date of the corporate action or security. [Corps.C. § 119(e)(1)]

So long as the corporate action is one that can be ratified or validated (¶ 6:597.60 ff.), the statute does *not* prescribe or circumscribe the facts and circumstances the court may consider or what remedies it may grant. The court may make *any* order concerning the corporate action that "justice and equity may require." [Corps.C. § 119(e)(2)]

(1) [6:597.41] **Persons authorized to file petition:** An "authorized person" means the corporation (or a successor entity), a director, shareholder, or holder of purportedly issued shares, or any other person claiming to be "substantially and adversely affected" by the ratification. [Corps.C. § 119(e)(6)]

(2) [6:597.42] **Proper county for filing:** The "proper county" in which to file the petition is (i) the county where the corporation's principal office is located, or (ii) if the corporation's principal office is not located in California, the county where its agent for service of process is located. [Corps.C. § 119(e)(4)]

(3) [6:597.43] **Time for filing:** The petition must be filed no later than *180 days* after the notice of ratification required by Corps.C. § 119(c) (¶ 6:597.25). [Corps.C. § 119(e)(3)]

(a) [6:597.44] **Exceptions:** The 180-day period does *not* apply to (i) an action asserting that a ratification did not comply with Corps.C. § 119 or (ii) any person who was entitled to, but was not given, Corps.C. § 119(c) notice. [Corps.C. § 119(e)(3)]

(4) [6:597.45] **Service of petition:** Service of the petition on the corporation's registered agent is deemed to be service on the corporation, and no other party needs to be joined for the court to adjudicate the matter. [Corps.C. § 119(e)(5)]

(5) [6:597.46] **Notice to other persons; intervention:** The court *may* require notice of the action to be provided to other persons and may permit those persons to intervene in the action. [Corps.C. § 119(e)(5)]

(6) [6:597.47] **Identification of other pending legal proceedings:** Any petition seeking judicial validation must identify every pending legal proceeding of which the petitioner is aware and in which (i) the validity of the corporation's action is being directly challenged, *or* (ii) validation would result in the proceeding's dismissal, in whole or in part. [Corps.C. § 119(e)(7)]

If the petitioner becomes aware of any *additional* such legal proceeding, the petitioner must amend (or, if applicable, move for leave to amend) the petition within *10 court days* to identify the proceeding (including the venue or forum in

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

which filed), any case number or other unique identifier assigned to it, the parties' names, and the filing date. [Corps.C. § 119(e)(7)]

(7) [6:597.48] **Certificate of validation:** Where a court-validated corporate action would have required a filing with the Secretary of State or would cause any instrument previously filed with the Secretary of State to be inaccurate or incomplete in any material respect after giving effect to the validation, the corporation must file a certificate of validation to make, amend, or correct each such instrument. The certificate of validation will have the specified effect and must be filed with the Secretary of State. The certificate "shall" consist of an "officers' certificate" including *all* of the following information:

• the corporation's name and Secretary of State's file number (Corps.C. § 119(f)(1));

• the title of any such instrument being made, amended, or corrected (Corps.C. § 119(f)(2));

• the date the instrument was filed with the Secretary of State (or a statement that the instrument was not previously filed with the Secretary of State), and, as applicable, a statement that the validation would cause the instrument to be inaccurate or incomplete in any material respect after giving effect to the validation (Corps.C. § 119(f)(3));

• the date the instrument shall be deemed effective (which may be before or after the filing date) (Corps.C. § 119(f)(4));

• a statement that the certificate of validation is making, amending, or correcting the instrument, together with a copy of the instrument, containing all required information (an attached instrument need not be separately executed and acknowledged and need not include a statement that such instrument has been approved in accordance with another section's provisions) (Corps.C. § 119(f)(5)); *and*

• a statement that the validation has been ordered pursuant to Corps.C. § 119(e) and a copy of the court's order (Corps.C. § 119(f)(6)).

[6:597.49 - 6:597.59] ***Reserved.***

c. [6:597.60] **Limitations on ratification and validation rights:** The Corps.C. § 119 ratification and validation rights (¶ 6:597.20 ff.) are limited as follows:

(1) [6:597.61] **Dissolved or foreign corporations:** The ratification and judicial validation procedures may not be used by dissolved or foreign corporations. [Corps.C. § 119(a)(4)]

(2) [6:597.62] **Prohibition on ratification or validation of specified actions:** The ratification and validation procedures may not be used for corporate actions regarding noncompliance with any of the following:

• Corps.C. § 309(a) (director's performance of duties) (¶ 6:243 ff.);

• Corps.C. § 310(a) or (b) (corporate contract or transaction in which director has material financial interest) (¶ 6:285 ff.);

• Corps.C. § 315 (corporation's loan to, or guarantee of obligation of, director or officer) (¶ 6:472 ff.);

• Corps.C. § 500(a) (requiring certain amount of retained earnings after shareholder distributions) (¶ 7:21 ff.); *or*

• Corps.C. § 501 (prohibiting distributions causing inability to meet corporation's liabilities) (¶ 7:42 ff.). [Corps.C. § 119(a)(5)]

d. [6:597.63] **Relation back:** Unless otherwise stated in the resolutions adopted pursuant to Corps.C. § 119(b) (¶ 6:597.21 ff.) or determined by the court pursuant to Corps.C. § 119(e) (¶ 6:597.40 ff.), a ratified or validated corporate action or corporate security relates back to the date of the original corporate action. [Corps.C. § 119(g)]

e. [6:597.64] **Retention of records:** The corporation must retain all records related to the ratification or validation of a corporate action under Corps.C. § 119 in accordance with Corps.C. § 1500 (¶ 6:153). [Corps.C. § 119(i)]

f. [6:597.65] **Stay of ratification or validation due to pending proceedings:** If the corporation is a party to a pending legal proceeding in which (1) the validity of a corporation action sought to be ratified or validated is at issue, or (2) the ratification or validation of a corporation action would result in the dismissal in whole or in part of the proceeding, the corporation must

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

notify the judge, arbitrator, or other person presiding over the proceeding *at least 10 court days* before adopting resolutions pursuant to Corps.C. § 119(b) (¶ 6:597.21 ff.) or filing a petition pursuant to Corps.C. § 119(e) (¶ 6:597.40 ff.) concerning that corporation action. The person so notified has the power to stay the ratification or validation as justice and equity may require. [Corps.C. § 119(j)]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 6-G

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

G. Shareholder Suits

1. [6:598] Introduction
    - a. [6:598.1] Direct *or* derivative action ordinarily permitted
        - (1) [6:598.2] Potential exception in small corporations
        - (2) [6:598.3] Compare—*separate direct and derivative actions permitted*
    - b. [6:598.6] Compare—benefit enforcement proceeding (benefit corporations)
2. [6:599] Direct (Individual) Actions
    - a. [6:600] Class actions
    - b. [6:601] Examples
        - (1) [6:601a] Equitable considerations in closely-held corporations
        - (2) [6:601.1] Compare—no direct action for diminution in share value
        - (3) [6:601.2] Compare—no direct action by "putative" shareholders seeking lost corporate profits
        - (4) [6:601.5] Compare—no direct action by "beneficial owner" of stock fraudulently held by shill
    - c. [6:601.11] Attorney's representation of corporation and defendant shareholders
3. [6:602] Derivative Suits
    - a. [6:603] Nature of action
        - (1) [6:604] Examples
            - (a) [6:604.3d] Compare—no derivative action for violation of Sarbanes-Oxley Act § 304
        - (2) [6:604.4] Compare—actions exempt from derivative suit procedural requirements
            - (a) [6:604.4a] Application to SPCs?
        - (3) [6:604.5] Compare—shareholder/president cannot avoid derivative suit requirements by bringing direct action in corporate name
        - (4) [6:604.10] Limitation—no derivative suit against corporate counsel absent waiver of attorney-client privilege
            - (a) [6:604.11] "Crime-fraud" exception
        - (5) [6:605] Who recovers
            - (a) [6:606] Compare—recovery by individual shareholders
                - 1) [6:607] Examples
                - 2) [6:610] Comment
        - (6) [6:611] Corporation an indispensable party-defendant
            - (a) [6:611.1] Corporation's limited capacity to defend action
                - 1) [6:611.2] Comment—potentially disruptive claims
            - (b) [6:612] Joint representation of corporation and director defendants—conflict of interest problems

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) Application
2) [6:612d] Caution—disclosure of confidential or privileged information
3) [6:612.1] Compare—no attorney-client relationship between corporation and *plaintiff's* counsel
4) [6:612.1a] Compare—attorney's representation of director defendants despite prior representation of corporation
(7) [6:612.2] Right to jury trial
(8) [6:612.3] “Double” derivative suits
(9) [6:612.4] “Internal affairs” doctrine (Corps.C. § 2116) as limitation on derivative suits against foreign corporations
b. Qualifications of plaintiffs
(1) [6:613] Must be a shareholder
(a) [6:613.1] Beneficial share ownership
1) [6:613.2] Shares held by partnership or joint venture
2) [6:613.3] Shares held in trust
3) [6:613.4] Shares held as community property
4) [6:613.10] Limitation—option holder not beneficial share owner
(b) [6:614] Contemporaneous ownership requirement
1) Exceptions
a) [6:615] Operation of law
b) [6:616] No one else to enforce claim (“continuing wrong” doctrine)
c) [6:617] Securities Exchange Act § 16(b)
(c) [6:618] Continued ownership required throughout litigation
1) [6:618.1] Same rule in federal court actions
2) [6:618.2] Ordinarily, no exception for involuntary sale of stock
a) [6:618.3] Effect on recovery of shareholder's litigation expenses
b) [6:619] Potential exception for sham forced buy-out
(d) [6:619.5] Action by shareholder of dissolved corporation
(e) [6:620] Controlling shareholder and corporation disqualified
(f) [6:620a] Must “adequately represent” other shareholders (federal actions)
1) [6:620.1] Shareholder with individual claims against corporation disqualified
(2) [6:621] Compare—direct action by former shareholders
c. [6:622] Demand on board of directors prior to filing suit
(1) [6:623] Demand must identify shareholder
(2) [6:624] Pleading requirements
(3) [6:625.1] Board rejection of demand
(4) [6:626] Demand excused when futile
(a) [6:626.1] Pleading of specific facts required
1) [6:626.2] No discovery to prove futility
(b) [6:626.3] Test for futility in challenging board action
1) [6:626.4] Alternative test where no board action
2) [6:626.4a] Compare—Delaware test for assessing demand futility
3) [6:626.5] “Disinterested”
a) [6:626.6] Director's potential liability as excusing demand
4) [6:626.7] “Independent”
a) [6:626.8] Board dominated by wrongdoing directors or controlling shareholder
5) [6:626.9] Demand not excused where action alleges violation of federal proxy rules
6) [6:627] Majority of board involved in wrongdoing

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [6:627a] Series of interested director transactions—majority need not participate in each transaction
7) [6:627.1] Compare—directors not accused of wrongdoing
(c) [6:627.2] Futility determined as of date of complaint
(d) [6:628] Derivative claims brought in federal court
(e) [6:629] Board appointment of special litigation committee as excusing demand
(5) [6:629.5] Defendant can raise failure to make demand
d. Directors' discretion to bar suit
(1) [6:630] Rejecting shareholder demand
(a) [6:631] Good faith business judgment required
1) [6:632] Independent majority
a) [6:633] Insider trading violations
2) [6:633.1] Reasonable investigation
3) [6:633.2a] Reliance upon counsel who also represented alleged wrongdoers
4) [6:633.3] "Cost-benefit" analysis
(2) [6:634] Dismissal by special litigation committee
(a) [6:636] Dismissal required if committee exercised good faith business judgment
1) [6:637] Independence of committee members
a) [6:638] Appointment of additional directors
2) [6:639] Investigation
3) [6:639.2] "Cost-benefit" analysis
4) [6:639.3] No discovery of committee report or materials
(b) [6:640] Compare—other states
1) [6:642.1] Comment
e. [6:643] Security for defendants' expenses
(1) [6:644] Who may require security
(2) [6:645] Who must post security
(a) [6:646] Exception for shareholder-intervenor in involuntary dissolution proceeding
(3) [6:646.1] Court order must be obtained
(a) [6:647] Time for motion
(b) [6:648] Effect of filing motion
(c) [6:649] Grounds for motion
1) [6:650] No "reasonable possibility" suit will benefit corporation
a) [6:651] Application unclear
2) [6:652] Moving party not a participant in challenged transaction
(d) [6:653] Burden of proof on moving party
(e) [6:654] Hearing on motion
(f) [6:655] Issuance of order
1) [6:655.1] Amount of bond
2) [6:656] Not a decision on the merits
(g) [6:657] Suit dismissed if plaintiff fails to post security
1) [6:657.1] Defendant not entitled to attorney fees
(4) [6:658] Plaintiff may avoid dismissal by posting bond
(a) [6:658.1] Prevailing defendant relieved of showing "no reasonable possibility" of benefit to corporation
1) [6:658.2] Effect
(b) [6:658.6] Compare—other statutory requirements not supplanted by bond
(5) [6:659] Prevailing defendants entitled to claim security
(a) [6:659.1] "Prevailing party" determination

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) [6:659.6] Recovery of litigation expenses limited to security
(c) [6:660] Compare—liability for court costs
(6) Application to derivative suits in federal court
(a) [6:661] Diversity cases
(b) [6:662] Securities law cases
(c) [6:663] Supplemental claims
f. [6:664] Defenses to derivative suits
(1) [6:665] Exception—corporate incapacity to sue caused by defendants
(2) [6:666] Equitable defenses
(3) [6:666.1] Waiver and res judicata
g. [6:667] Settlement and recovery
(1) [6:667.1] Shareholder standing to object to settlement
(2) [6:667.2] Settlement as bar to subsequent suit (claim preclusion)
(3) [6:667.10] Settlement no bar to malpractice claim against counsel
h. [6:668] Payment of plaintiff's expenses
(1) [6:670] Application in derivative action against other shareholders in closely-held corporation
(a) [6:670.1] Distinguish—plaintiff shareholder receiving *personal* benefit
(2) [6:670.5] Effect of involuntary sale of plaintiff's stock during derivative action
(3) [6:670.6] Court approval of attorney fees negotiated as part of settlement
i. [6:671] Indemnification of directors and officers
(1) [6:672] Insurance against derivative liability

1. [6:598] **Introduction:** Shareholders may bring two types of actions:

• A *direct* action filed by the shareholder individually (or on behalf of a *class* of shareholders to which they belong) for injury to their interest *as a shareholder;* or

• A *derivative* action filed on *behalf of the corporation* for *injury to the corporation* for which it has failed or refused to sue. [*Schuster v. Gardner* (2005) 127 CA4th 305, 311-312, 25 CR3d 468, 473 (quoting text); see *Oakland Raiders v. National Football League* (2005) 131 CA4th 621, 650-651, 32 CR3d 266, 288 (quoting text); see also *Sprengel v. Zbylut* (2019) 40 CA5th 1028, 1040-1041, 253 CR3d 561, 569-570 (case involving LLC but principles equally applicable to corporations)]

a. [6:598.1] **Direct *or derivative action ordinarily permitted:*** Ordinarily, the two actions are mutually exclusive: i.e., the right of action and recovery belongs to *either* the *shareholders* (direct action) *or* the *corporation* (derivative action). [*Schuster v. Gardner* (2005) 127 CA4th 305, 312, 25 CR3d 468, 473 (quoting prior version of text); see *Bader v. Anderson* (2009) 179 CA4th 775, 793, 101 CR3d 821, 835 (quoting text); *Oakland Raiders v. National Football League* (2005) 131 CA4th 621, 649, 32 CR3d 266, 287, fn. 26 (quoting prior version of text)]

(1) [6:598.2] **Potential exception in small corporations:** However, the distinction between direct and derivative actions sometimes blurs, especially in corporations with only a few shareholders where the acts of one officer/shareholder directly impact both the corporation *and* the *other shareholders*. Consequently, courts have permitted a *direct* shareholder action, or given direct shareholder *recovery* in a *derivative* action, when it was equitable to do so. [See *Jara v. Suprema Meats, Inc.* (2004) 121 CA4th 1238, 1253-1260, 18 CR3d 187, 198-204 (*discussed at ¶ 6:601a ff.*); *and ¶ 6:606*; compare *Hilliard v. Harbour* (2017) 12 CA5th 1006, 1015, 219 CR3d 613, 619—78-year-old controlling shareholder could not maintain direct action under guise of Elder Abuse and Dependent Adult Civil Protection Act (Welf. & Inst.C. § 15600 et seq.) where harm was directly to corporation and his injury arose solely by reason of being shareholder]

(2) [6:598.3] **Compare—*separate direct and derivative actions permitted:*** Of course, a shareholder may have *separate* direct and derivative claims; if so, they may maintain both a direct action and a derivative action. "[I]t is settled that one who has suffered injury both as an owner of a corporate entity and in an individual capacity is entitled to pursue remedies in both capacities." [*Denevi v. LGCC* (2004) 121 CA4th 1211, 1221-1222, 18 CR3d 276, 284; see *Goles v. Sawhney* (2016) 5 CA5th 1014, 1018, 210 CR3d 261, 264, fn. 3]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[6:598.4 - 6:598.5] ***Reserved.***

b. [6:598.6] **Compare—benefit enforcement proceeding (benefit corporations):** A benefit enforcement proceeding may be brought in the form of a derivative action to redress a benefit corporation's failure to pursue its general or specific public benefit purpose, violation of a director's duty or standard of conduct, or failure to deliver or post an annual benefit report (¶ *9:600 ff.*). Such a proceeding is not governed by Corps.C. § 800 but, rather, by statutory provisions unique to benefit corporations. [Corps.C. §§ 14601(b), 14623; *see discussion at* ¶ *9:582 ff.*]

2. [6:599] **Direct (Individual) Actions:** Where the duty breached is owed *directly to the shareholder as an individual*, the shareholder may bring suit and obtain judgment on their own behalf.

The cause of action need not be *unique* to the plaintiff-shareholder. So long as "the injury is not incidental to an injury to the corporation," a direct individual action may be brought even though the same injury affects a substantial number of shareholders. [*Jones v. H.F. Ahmanson & Co.* (1969) 1 C3d 93, 107, 81 CR 592, 599; *Vega v. Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 297, 17 CR3d 26, 37]

a. [6:600] **Class actions:** Indeed, where the misconduct similarly affects the rights of a number of other shareholders, the shareholder bringing suit may maintain a *class action*—i.e., sue as a *representative* of the class of shareholders similarly wronged and damaged. [See CCP § 382; FRCP 23; and Stevenson & Fitzgerald, *Rutter Group Prac. Guide: Federal Civ. Pro. Before Trial* (TRG), Ch. 10]

b. [6:601] **Examples:** Examples of *direct* shareholder actions include suits brought:

- Where management abridges a shareholder's right to inspect corporate books and records (¶ *6:516*);
- Where the corporation violates shareholders' preemptive rights (¶ *3:180*);
- Where controlling shareholders breach fiduciary duties owed to the minority in transferring control shares (¶ *6:346 ff.*);
- Where directors issue stock to themselves to shift control of the corporation; [see *Sheppard v. Wilcox* (1962) 210 CA2d 53, 64, 26 CR 412, 420—essence of action is fraud against other shareholders, not the corporation]
- Where insiders engage in prohibited trading in the corporation's securities (e.g., purchasing or selling shares without disclosing material inside information; ¶ *6:372*);
- Where management engages in a misleading proxy solicitation (*see* ¶ *8:372*);
- Where directors improperly refuse to declare a dividend (¶ *7:78 ff.*);
- To compel payment of lawfully declared dividends (¶ *7:85*) or mandatory dividends (¶ *3:97*);
- To sue for extracontract damages resulting from an insurer's "bad faith" handling of the corporation's claim where the corporation and its sole shareholders were jointly insured; [see *Truestone, Inc. v. Travelers Ins. Co.* (1976) 55 CA3d 165, 171, 127 CR 386, 390—implied covenant of good faith and fair dealing ran to shareholders as well as to corporation]
- To enjoin a threatened ultra vires act (¶ *4:22*);
- To enforce shareholder voting rights;
- To challenge the election or appointment of a director (¶ 6:153.10 ff., 6:239);
- To recover for breaches of shareholder agreements;
- To compel dissolution (¶ *8:813 ff.*); and

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- To enjoin a proposed dissolution (¶ *8:843*), merger or sale of corporate assets (¶ *8:605*). [See *Schuster v. Gardner* (2005) 127 CA4th 305, 313, 25 CR3d 468, 474 (citing text)]

(1) [6:601a] **Equitable considerations in closely-held corporations:** In corporations with only a few shareholders, harmful acts by one officer/shareholder may directly impact the other shareholders, and hence courts are more willing to allow direct actions. [*Jara v. Suprema Meats, Inc.* (2004) 121 CA4th 1238, 1253-1257, 18 CR3d 187, 198-202]

- [6:601b] Excessive officer compensation is a classic example of a *corporate* harm that should ordinarily be remedied through a *derivative* action. But where two officer/shareholders in a three-shareholder corporation agree to pay themselves excessive compensation, there is no point in forcing the third shareholder to sue derivatively: Plaintiff seeks a portion of the "disguised dividends" paid to the other shareholders, and the remedy would not benefit the corporation or the other shareholders. [*Jara v. Suprema Meats, Inc.* (2004) 121 CA4th 1238, 1257-1260, 18 CR3d 187, 202-204]

(2) [6:601.1] **Compare—no direct action for diminution in share value:** However, a shareholder *cannot* bring a direct action for damages against management on the theory their alleged wrongdoing decreased the value of their stock (e.g., by reducing corporate assets and net worth). The corporation itself must bring such an action, or a derivative suit may be brought on the corporation's behalf (¶ 6:602). Reason: Allowing such an action would authorize multitudinous litigation and ignore the corporate entity. [*Schuster v. Gardner* (2005) 127 CA4th 305, 312, 25 CR3d 468, 473 (quoting text); *Bader v. Anderson* (2009) 179 CA4th 775, 799-801, 101 CR3d 821, 840-842; see *Sutter v. General Petroleum Corp.* (1946) 28 C2d 525, 529-530, 170 P2d 898, 900-901]

For the same reason, a shareholder cannot use diminution in share or corporate value as justification for bringing a direct action against a *third party* for harm done to the corporation. [See *United States v. Stonehill* (9th Cir. 1996) 83 F3d 1156, 1160-1161—no shareholder direct action against town for depressing value of corporation's property through illegal zoning; *Vinci v. Waste Mgmt., Inc.* (9th Cir. 1996) 80 F3d 1372, 1375—shareholder of corporation injured by antitrust violations cannot bring direct action]

(3) [6:601.2] **Compare—no direct action by "putative" shareholders seeking lost corporate profits:** In the situation of a corporation that failed to issue stock, the would-be shareholders cannot bring a direct action against a third party to recover their pro rata shares of lost corporate profits (or other damages suffered by the corporation). The failure to issue shares does not give the putative shareholders a direct claim to lost corporate profits: The lost profits remain an injury to the *corporation*, rendering the putative shareholders' claims *derivative* in nature. [*Sole Energy Co. v. Petrominerals Corp.* (2005) 128 CA4th 212, 228-232, 26 CR3d 798, 809-813 (action against third parties for fraud and interference with prospective economic advantage arising from corporation's thwarted acquisition of oil and gas company)]

[6:601.3 - 6:601.4] ***Reserved.***

(4) [6:601.5] **Compare—no direct action by "beneficial owner" of stock fraudulently held by shill:** A person who seeks to conceal assets from creditors by arranging to have their corporate shares held in an accomplice's name cannot bring suit against a third party for injury to the corporation: One who disclaims ownership interest in the corporation cannot thereafter assert a claim for injury to that interest. Moreover, where the denial or concealment of ownership occurred in a *legal proceeding*, such as bankruptcy, the doctrine of *judicial estoppel* may bar the person from asserting a totally inconsistent position in another lawsuit. [*Thomas v. Gordon* (2000) 85 CA4th 113, 117-123, 102 CR2d 28, 32-36—physician who avoided creditors in bankruptcy proceeding by transferring shares in her professional corporation to paramour barred from asserting malpractice claim against corporation's accountant for paramour's waste of assets]

[6:601.6 - 6:601.10] ***Reserved.***

c. [6:601.11] **Attorney's representation of corporation and defendant shareholders:** *See* ¶ *1:11.2a*.

3. [6:602] **Derivative Suits:** A shareholder may bring a derivative suit on the corporation's behalf where management (or any third party) breaches a duty *owed to the corporation* and the corporation *fails to assert* its cause of action. The shareholder is merely a nominal plaintiff in such an action. Even though the corporation is joined as a nominal defendant (¶ *6:611*), it is the real party in interest to which any recovery usually belongs. [See *Grosset v. Wenaas* (2008) 42 C4th 1100, 1108, 72 CR3d 129,

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

135 (citing text); *Schuster v. Gardner* (2005) 127 CA4th 305, 312, 25 CR3d 468, 473 (quoting text); *Vega v. Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 297, 17 CR3d 26, 37 (citing text)]

a. [6:603] **Nature of action:** A derivative suit is equitable in nature. Shareholders have no direct cause of action against persons who have harmed the corporation; but, through the vehicle of the derivative suit, they may "secondarily" or "*derivatively*" enforce the corporation's rights and redress its injuries where management fails or refuses to do so (usually because management is alleged to have inflicted the harm). [See *Grosset v. Wenaas* (2008) 42 C4th 1100, 1108, 72 CR3d 129, 135 (citing text); *Vega v. Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 297, 17 CR3d 26, 37 (citing text)]

Thus, an action is "derivative" if "the gravamen of the complaint is injury to the corporation, or to the whole body of its stock and property without any severance or distribution among individual holders, or [if] it seeks to recover assets for the corporation or to prevent the dissipation of its assets." [*Grosset v. Wenaas*, supra, 42 C4th at 1108, 72 CR3d at 135-136; see *Hilliard v. Harbour* (2017) 12 CA5th 1006, 1015, 219 CR3d 613, 619, *discussed at* ¶ *6:598.2*; *Avikian v. WTC Fin'l Corp.* (2002) 98 CA4th 1108, 1115, 120 CR2d 243, 248—claim that controlling shareholders/directors/officers breached duty to minority shareholders was derivative because plaintiffs' injury from defendants' mismanagement was "merely incidental" to corporation's injury]

(1) [6:604] **Examples:** Shareholders may bring derivative suits to enable the corporation to:

• [6:604.1] Enjoin or recover damages for breaches of fiduciary duty owed the corporation by *directors* (¶ *6:243 ff.*), controlling shareholders (¶ *6:335*) or *officers* (¶ *6:280*)—e.g., due to mismanagement of the business, misappropriation of corporate assets or opportunities (¶ *6:285 ff.*), or misleading communications to shareholders;

• [6:604.2] Enjoin or recover damages for wrongs against the corporation by *third parties*;

• [6:604.3] Recover damages resulting from consummated *ultra vires* activities (¶ *4:22*). [See *Bader v. Anderson* (2009) 179 CA4th 775, 799-801, 101 CR3d 821, 840-842; *Schuster v. Gardner* (2005) 127 CA4th 305, 313, 25 CR3d 468, 474 (citing text); *Nelson v. Anderson* (1999) 72 CA4th 111, 125-127, 84 CR2d 753, 762-763; see also *Speirs v. BlueFire Ethanol Fuels, Inc.* (2015) 243 CA4th 969, 983, 197 CR3d 25, 37, fn. 7—claim that corporation issued new securities for inadequate consideration and thereby improperly diluted value of existing securities is derivative in nature (dictum)]

[6:604.3a - 6:604.3c] ***Reserved.***

(a) [6:604.3d] **Compare—no derivative action for violation of Sarbanes-Oxley Act § 304:** There is no implied private right of action, and hence no derivative action may be maintained, for a breach of fiduciary duty in violation of Sarbanes-Oxley Act § 304 (15 USC § 7243), which provides for disgorgement of bonuses paid to a chief executive officer and chief financial officer who fail to comply with the Act's financial reporting requirements. [*In re Digimarc Corp. Derivative Litig.* (9th Cir. 2008) 549 F3d 1223, 1229-1233]

(2) [6:604.4] **Compare—actions exempt from derivative suit procedural requirements:** Certain shareholders and corporate *creditors* may bring suit on the corporation's behalf to recover damages from directors responsible for making improper distributions, loans or loan guarantees; or to force the receiving shareholders to return improper distributions to the corporation. Although such actions are "derivative," they are *not* subject to the procedural requirements of Corps.C. § 800, discussed below (e.g., the plaintiff need not make a demand on the corporation, and cannot be required to post a bond; ¶ *6:613 ff.*). [Corps.C. §§ 316(c), 506(b); *see* ¶ *6:479, 7:141 ff.*]

(a) [6:604.4a] **Application to SPCs?** The derivative suit "exemption" contained in Corps.C. §§ 316(c) and 506(b) refers specifically to Corps.C. § 800. Derivative actions brought on behalf of an SPC are not governed by Corps.C. § 800 but, rather, by Corps.C. § 2900 (*see* ¶ *9:161 ff.*). The failure to include a reference to Corps.C. § 2900 in Corps.C. §§ 316(c) and 506(b) is probably a legislative oversight.

(3) [6:604.5] **Compare—shareholder/president cannot avoid derivative suit requirements by bringing direct action in corporate name:** The president of a corporation has no inherent or presumptive authority to bring a direct action in the corporate name to redress harm done by individual directors. Where the bylaws confer no such authority, the president/50% shareholder may *not* purport to file suit on behalf of the corporation against the other shareholder as a vehicle to break a board deadlock. "Pressing the corporation into litigation as a plaintiff is inappropriate where the other shareholder-director could claim equal authority to bring suit in the corporate name." [*Anmaco, Inc. v. Bohlken* (1993) 13 CA4th 891, 900, 16 CR2d 675, 679]

• [6:604.6] **Comment:** While *Anmaco* stated in dictum that a derivative action against a director is the proper vehicle when the gravamen of the complaint is injury to the corporation, the court clearly would have also disallowed a *derivative* action as a tool to resolve a deadlock among two 50% shareholders.

Rather, the proper approach is to invoke the "usual remedies available in the case of a deadlock in a small corporation," such as appointment of a provisional director (Corps.C. § 308, ¶ *6:232.1*), removal of a dishonest or fraudulent director (Corps.C. § 304, ¶ *6:239*), or the more extreme measures of involuntary dissolution (Corps.C. § 1800 et seq., ¶ *8:794*) or appointment of a receiver (Corps.C. § 1803, CCP § 564(b)(5) & (6), ¶ *8:841*). [See *Anmaco, Inc. v. Bohlken* (1993) 13 CA4th 891, 900, 16 CR2d 675, 679, fn. 3]

[6:604.7 - 6:604.9] ***Reserved.***

(4) [6:604.10] **Limitation—no derivative suit against corporate counsel absent waiver of attorney-client privilege:** The corporation, not its shareholders, is the holder of the attorney-client privilege; hence, shareholders do not effect a waiver of the privilege by filing a derivative action against corporate counsel. Absent a waiver by the corporate client (acting by its board of directors), outside counsel is effectively prevented from mounting any meaningful defense to a shareholder derivative suit for malpractice. For that reason, such a suit is barred. [*McDermott, Will & Emery v. Sup.Ct. (James)* (2000) 83 CA4th 378, 383-386, 99 CR2d 622, 626; see *Reilly v. Greenwald & Hoffman, LLP* (2011) 196 CA4th 891, 896-897, 127 CR3d 317, 320—same principles apply to derivative malpractice action against *dissolved* corporation's outside counsel; *Favila v. Katten Muchin Rosenman LLP* (2010) 188 CA4th 189, 217-222, 115 CR3d 274, 297-300]

(a) [6:604.11] **"Crime-fraud" exception:** There is no attorney-client privilege—and hence no need to obtain a corporate waiver before allowing a derivative suit against corporate counsel—if counsel's services "were sought or obtained to enable or aid anyone to commit or plan to commit a crime or a fraud." [Ev.C. § 956(a); see *Favila v. Katten Muchin Rosenman LLP* (2010) 188 CA4th 189, 220-222, 115 CR3d 274, 299-300]

(5) [6:605] **Who recovers:** Since a derivative suit enforces a corporate cause of action, any recovery ordinarily goes to the corporation rather than to the plaintiff-shareholder. (But the plaintiff-shareholder may be reimbursed for litigation expenses incurred in obtaining the recovery; ¶ *6:668*.) [See *Avikian v. WTC Fin'l Corp.* (2002) 98 CA4th 1108, 1115, 120 CR2d 243, 248; also see *Cotton v. Expo Power Systems, Inc.* (2009) 170 CA4th 1371, 1379-1380, 89 CR3d 112, 119-120—derivative action is corporate asset that can be valued when appraising interest of minority shareholder seeking dissolution (Corps.C. § 2000; ¶ *8:873.6*)]

(a) [6:606] **Compare—recovery by individual shareholders:** Under unusual circumstances, where recovery by the corporation would result in a *windfall* benefit to some undeserving shareholders, the court may grant recovery directly to other (deserving) shareholders.

1) [6:607] **Examples:** This may occur where a controlling interest in the corporation is purchased *after* the alleged wrongdoing that is the basis for the derivative suit.

• [6:607.1] For example, assume X sold Y 80% of the stock in XYZ Corp. Prior to the sale, X illegally depleted XYZ's assets by $100,000; but X *fully disclosed* the transaction to Y and *reduced* the sales price to reflect the reduction in corporate assets. If a minority shareholder brings a derivative suit to force X to restore $100,000 to the corporation, a recovery by the corporation would give Y a windfall "reduction" in the already discounted purchase price he paid for the stock; i.e., he would indirectly receive an $80,000 refund. [See, e.g., *Halprin v. Babbitt* (1st Cir. 1962) 303 F2d 138, 141]

[6:608] To avoid such an anomalous result, X may be required to pay *directly* and pro rata to the other shareholders (holding 20% of the stock) their allocable share of the diverted assets ($20,000). [See *Rankin v. Frebank Co.* (1975) 47 CA3d 75, 96, 121 CR 348, 361-362; and *Matthews v. Headley Chocolate Co.* (Md. 1917) 100 A 645]

• [6:609] Or, assume that A sells his 40% interest in XYZ Corp. to B, a principal corporate customer. B pays a premium for the shares because they give him control of the corporation. A derivative suit is brought on the ground that sale of such a controlling interest is detrimental to the corporation (¶ *6:349*), and seeks to force A to return his control premium to the corporation. B will benefit from such suit to the extent of 40% of the corporation's recovery—a windfall reduction in the purchase price B paid. Accordingly, it is appropriate to order A to share 60%

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

of his control premium *directly* with the other shareholders (holding 60% of the outstanding stock). [See *Perlman v. Feldmann* (2nd Cir. 1955) 219 F2d 173, 178]

2) [6:610] **Comment:** On the other hand, an individual recovery may be inappropriate where it prejudices the corporation's *creditors* because the corporation itself does not fully recover on its cause of action. [See, e.g., *Glenn v. Hoteltron Systems, Inc.* (NY App. 1989) 74 NY2d 386, 392-393, 547 NE2d 71, 74]

(6) [6:611] **Corporation an indispensable party-defendant:** The corporation must be joined as a *nominal* defendant in a derivative action. The corporation is an indispensable party because its rights are being litigated, and a court has no jurisdiction to adjudicate such rights in its absence. [*Keeler v. Schulte* (1957) 47 C2d 801, 803, 306 P2d 430, 431-432; *Stockton v. Ortiz* (1975) 47 CA3d 183, 191-192, 120 CR 456, 460-461]

Of course, the plaintiff must name and serve at least one other *real* defendant against whom relief is sought (e.g., corporate officers and/or directors).

(a) [6:611.1] **Corporation's limited capacity to defend action:** Although a *nominal* defendant, the corporation is actually a *plaintiff* to the extent it would obtain a recovery in the derivative action (*see ¶ 6:605*). As such, the corporation's capacity to defend the action is extremely limited. It may assert *procedural* defenses contesting the plaintiff-shareholder's right or decision to bring the action, such as the shareholder's lack of standing (*see ¶ 6:613 ff.*) or a disinterested board majority's rejection of the shareholder's demand for bringing an action against the wrongdoers (*¶ 6:630*). It may also assert defenses that would preclude the action—e.g., it has already brought suit against the wrongdoers or has already recovered (or by final adjudication has failed to recover) against them. But the corporation generally may *not* oppose the derivative action *on the merits.* To hold otherwise would allow the wrongdoer defendants to shift the cost of their defense to the corporation. [*Patrick v. Alacer Corp.* (2008) 167 CA4th 995, 1004-1010, 84 CR3d 642, 651-657]

1) [6:611.2] **Comment—potentially disruptive claims:** In response to the concern about a "patently meritless action," the court in *Patrick*, supra, noted that such was not the situation in that case and that the wrongdoer defendants (directors) had successfully demurred to the action on largely the same grounds as the corporation. The court also noted that, in any event, a special litigation committee of disinterested directors could effect a dismissal of a truly meritless suit; and even if that were not possible, "no substantial harm appears to befall the corporation from merely awaiting the outcome and reaping the fruits of any judgment for plaintiffs." [*Patrick v. Alacer Corp.* (2008) 167 CA4th 995, 1010-1011, 84 CR3d 642, 656-657 (internal quotes omitted)]

However, various scenarios can be envisioned of a derivative action creating a greater potential of disruption to the corporation's business than recovery—e.g., a meritless action against corporate officers or directors (frequent targets in derivative actions), or even a meritorious action against a corporate supplier or customer. Presumably, the corporation would be permitted to defend in such a scenario. [See *Patrick v. Alacer Corp.*, supra, 167 CA4th at 1010, 84 CR3d at 656 ("This exception may well exist under California law, or it may not. We need not decide this here …")]

(b) [6:612] **Joint representation of corporation and director defendants—conflict of interest problems:** Here again, although the corporation is a nominal codefendant, its interests are normally *adverse* to the other defendants … especially where management personnel are charged with wrongdoing. Thus, an attorney cannot represent both the corporation and directors/shareholders who are accused of wrongdoing or whose interests are otherwise adverse to the corporation; and these directors cannot "waive" or consent to the inherent conflict of interest. [*Ontiveros v. Constable* (2016) 245 CA4th 686, 696-699, 199 CR3d 836, 844-846; *Forrest v. Baeza* (1997) 58 CA4th 65, 74-75, 67 CR2d 857, 863; *La Jolla Cove Motel & Hotel Apts., Inc. v. Sup.Ct. (Jackman)* (2004) 121 CA4th 773, 785-786, 17 CR3d 467, 476 (citing text)]

1) Application

• [6:612a] Minority (one-third) shareholders in a family-held corporation brought an action seeking involuntary dissolution (Corps.C. § 1800 et seq., *¶ 8:791 ff.*) on the ground that the two directors elected by plaintiffs had been systematically excluded from corporate governance. These directors' interests in the litigation were adverse to the corporation, and thus they could not be represented by counsel representing the corporation; they had to be represented by *separate* counsel. [*La Jolla Cove Motel & Hotel Apts., Inc. v. Sup.Ct. (Jackman)* (2004) 121 CA4th 773, 785-786, 17 CR3d 467, 476]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Moreover, plaintiffs' attorney need not obtain the consent of corporate counsel to contact the two directors and, indeed, could contact them over corporate counsel's objections. The consent of the directors' separate counsel to the ex parte contacts sufficed under former CRPC 2-100 (now CRPC 4.2) (attorney wishing to contact opposing party represented by counsel must first obtain counsel's consent). [*La Jolla Cove Motel & Hotel Apts., Inc. v. Sup.Ct. (Jackman)*, supra, 121 CA4th at 784-786, 17 CR3d at 474-476; see Haning, Flahavan, Cheng & Wright, *Cal. Prac. Guide: Personal Injury* (TRG), Ch. 2 Part I, for further discussion of ex parte contacts with opposing corporate party's directors, officers and employees]

[6:612b - 6:612c] ***Reserved.***

2) [6:612d] **Caution—disclosure of confidential or privileged information:** A director has continuing fiduciary duties to the corporation *notwithstanding any adversity to the corporation they may have in the derivative action*. Hence, the director may not make unwarranted disclosure—even to their separate attorney—of attorney-client privileged information, trade secrets or similar confidential corporate information. Such a disclosure may result in liability on the part of the director and, if applicable, *their separate attorney*. (Additionally, the corporation may seek appropriate remedies in the derivative action, including disqualification of the attorney from further participation in the case and, in certain circumstances, exclusion of improperly obtained evidence.) [*La Jolla Cove Motel & Hotel Apts., Inc. v. Sup.Ct. (Jackman)* (2004) 121 CA4th 773, 788, 17 CR3d 467, 478 (but finding no disclosure of privileged information)]

➪ [6:612e] ***PRACTICE POINTER:*** Separate counsel representing directors in derivative actions must act with caution to avoid violating their clients' fiduciary duties. "In most cases it would be advisable and prudent for separate counsel to consult with the corporation's counsel before allowing the director to have contact with counsel suing the corporation, to ensure that attorney-client privileged communications or other confidential information is not disclosed." [*La Jolla Cove Motel & Hotel Apts., Inc. v. Sup.Ct. (Jackman)* (2004) 121 CA4th 773, 788, 17 CR3d 467, 478]

3) [6:612.1] **Compare—no attorney-client relationship between corporation and *plaintiff's counsel:*** An attorney representing plaintiff in a derivative action does not ipso facto represent the corporation. Although the derivative plaintiff's attorney may be said to represent the corporation's *interests*, the derivative action does *not itself* give rise to an *attorney-client relationship* between the attorney and the corporation. Nor does the derivative action itself give rise to a duty of *fidelity or confidentiality* by plaintiff's attorney to the corporation. Therefore, absent other circumstances (e.g., attorney also corporate director or previously represented corporation), no conflict of interest arises if the derivative plaintiff's attorney also represents plaintiff in another action or matter directly against the corporation. [*Shen v. Miller* (2012) 212 CA4th 48, 56-58, 65-67, 150 CR3d 783, 789-791, 797-798]

4) [6:612.1a] **Compare—attorney's representation of director defendants despite prior representation of corporation:** *See ¶ 1:11.7p*.

(7) [6:612.2] **Right to jury trial:** Because a derivative action is equitable in nature, there is no right to a jury trial in state court. [*Rankin v. Frebank Co.* (1975) 47 CA3d 75, 90-92, 121 CR 348, 358-359]

However, if a derivative action is brought in *federal* court, the Seventh Amendment right to a jury trial applies to those issues upon which the *corporation* would have had a right to a jury trial had it brought the action. Thus, for example, plaintiff would be entitled to a jury trial in a federal derivative suit where the issue is the corporation's right to recover damages for breach of contract or negligence. [*Ross v. Bernhard* (1970) 396 US 531, 532-533, 90 S.Ct. 733, 735]

(8) [6:612.3] **"Double" derivative suits:** It is unsettled in California whether a shareholder of a *parent* corporation has standing to bring a derivative suit on behalf of its *subsidiary*—i.e., to enforce the *parent's right to sue derivatively* for wrongs to the subsidiary. However, courts applying California law appear to look favorably upon the "double" derivative suit concept. [See generally, *Gaillard v. Natomas Co.* (1985) 173 CA3d 410, 419, 219 CR 74, 79-80, fn. 7 (disapproved on other grounds by *Grosset v. Wenaas* (2008) 42 C4th 1100, 1119, 72 CR3d 129, 144, fn. 16); *In re Imperial Corp. of America* (9th Cir. 1996) 92 F3d 1503, 1510 & fn. 10]

Such an action has been permitted under the laws of states other than California (e.g., Illinois and Delaware) in acknowledgment of "the realities of the changing techniques and structures of the modern corporation." [See *Brown v.*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Tenney (Ill. 1988) 532 NE2d 230, 233-234; *Lambrecht v. O'Neal* (Del. 2010) 3 A3d 277, 281-286; also see *Villari v. Mozilo* (2012) 208 CA4th 1470, 1478-1479, 1485, 146 CR3d 556, 562, 567-568 & fn. 10 (applying Del. law)]

(9) [6:612.4] **"Internal affairs" doctrine (Corps.C. § 2116) as limitation on derivative suits against foreign corporations:** Corps.C. § 2116, a partial codification of the "internal affairs" doctrine (¶ 3:4.1 ff.), provides that foreign corporation directors are liable to the corporation for breach of their "official duty" according to the laws of the *state of incorporation*. Corps.C. § 2116, when combined with the law of the foreign corporation's place of incorporation, may have the effect of limiting derivative actions with respect to foreign corporations. [*Vaughn v. LJ Int'l, Inc*. (2009) 174 CA4th 213, 223-225, 94 CR3d 166, 173-175—shareholder bringing derivative action in California in name of British Virgin Islands corporation had to comply with BVI statute requiring BVI high court's prior approval of action; see *Jones v. Martinez* (2014) 230 CA4th 1248, 1253-1254, 179 CR3d 35, 38; *Kruss v. Booth* (2010) 185 CA4th 699, 713-723, 111 CR3d 56, 69-77]

b. Qualifications of plaintiffs

(1) [6:613] **Must be a shareholder:** The plaintiff in a derivative action must be a shareholder of record "or beneficially" (¶ 6:613.1 ff.), or the holder of a voting trust certificate (¶ 3:159.8). [Corps.C. § 800(b)(1); see also Corps.C. § 2900(d)(1) (SPCs)]

(a) [6:613.1] **Beneficial share ownership:** Corps.C. § 800(b)(1) does not indicate what is meant by "beneficially" owned shares. However, case law adopts "a liberal and expansive" interpretation. [See *Pearce v. Sup.Ct. (Berry Holding Co.)* (1983) 149 CA3d 1058, 1064, 197 CR 238, 240-242; *Patrick v. Alacer Corp.* (2008) 167 CA4th 995, 1011-1012, 84 CR3d 642, 657-658]

1) [6:613.2] **Shares held by partnership or joint venture:** Thus, shares held by a *partnership* or *joint venture* are considered owned beneficially by the respective *partners* or *joint venturers*. [See *Pearce v. Sup.Ct. (Berry Holding Co.)* (1983) 149 CA3d 1058, 1062-1063, 197 CR 238, 241 (dictum)]

2) [6:613.3] **Shares held in trust:** Shares held by a *trustee* are considered owned beneficially by the trust *beneficiaries*. [*Pearce v. Sup.Ct. (Berry Holding Co.)* (1983) 149 CA3d 1058, 1062-1067, 197 CR 238, 240-244—plaintiff who received substantial current income from trust containing corporate stock and was also contingent beneficiary of trust corpus was beneficial owner of her portion of corporate stock held in trust and hence could bring derivative action]

3) [6:613.4] **Shares held as community property:** Shares held by one *spouse* (or *registered domestic partner*) may be considered owned beneficially by the *other* spouse (or *registered domestic partner*) to the extent of a community property interest in the shares. [*Patrick v. Alacer Corp.* (2008) 167 CA4th 995, 1011-1012, 84 CR3d 642, 657-658 (wife having community property interest in husband's shares subsequently transferred to living trust brought derivative action following husband's death)]

[6:613.5 - 6:613.9] ***Reserved.***

4) [6:613.10] **Limitation—option holder not beneficial share owner:** A person having an unexercised stock option or right to purchase stock pursuant to a stock purchase agreement is *not* a beneficial share owner for Corps.C. § 800(b)(1) purposes. An option holder, like a warrant or convertible debenture holder, does not have the risks and benefits of stock ownership. [*Daly v. Yessne* (2005) 131 CA4th 52, 60-61, 31 CR3d 420, 426-427]

(b) [6:614] **Contemporaneous ownership requirement:** Further, plaintiff must have held such shareholder status *at the time of the wrong* to the corporation giving rise to the action. [Corps.C. § 800(b)(1)]

Thus, shareholders cannot bring derivative suits on account of wrongs occurring *before* they acquired their shares; nor can they "purchase causes of action" from a former shareholder. [*Pacific Lumber Co. v. Sup.Ct. (Martel)* (1990) 226 CA3d 371, 376, 276 CR 425, 428; see *Daly v. Yessne* (2005) 131 CA4th 52, 60-62, 31 CR3d 420, 426-428; compare *Kruss v. Booth* (2010) 185 CA4th 699, 724-727, 111 CR3d 56, 77-80—preacquisition wrongs that cannot form basis of action may nonetheless be relevant to show pattern of malfeasance continuing after acquisition]

1) Exceptions

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [6:615] **Operation of law:** The contemporaneous ownership requirement does *not* apply if plaintiff's shares “thereafter devolved” upon them by operation of law (e.g., by inheritance) from one who was a shareholder at the time of the transaction. [Corps.C. § 800(b)(1); see also Corps.C. § 2900(d)(1) (SPCs)]

b) [6:616] **No one else to enforce claim (“continuing wrong” doctrine):** Moreover, the court has discretion to waive the contemporaneous ownership requirement if it finds, upon motion and after an evidentiary hearing, that:

- There is a strong prima facie derivative claim;
- No other similar action has been or is likely to be instituted;
- Plaintiff acquired their shares before there was disclosure to plaintiff or to the public of the wrongdoing complained of;
- Defendants may retain a gain derived from their willful breach of fiduciary duty unless the action is allowed to proceed; and
- The requested relief will not unjustly enrich the corporation or any of its shareholders. [Corps.C. § 800(b)(1); see Corps.C. § 2900(d)(1) (SPCs); and *Kruss v. Booth* (2010) 185 CA4th 699, 724-725, 111 CR3d 56, 77-78 (but finding exception inapplicable where plaintiff sought no hearing)]

c) [6:617] **Securities Exchange Act § 16(b):** The contemporaneous ownership requirement also does not apply to shareholder suits to recover “short-swing” profits for the corporation under SEA § 16(b). [*Gollust v.Mendell* (1991) 501 US 115, 124-126, 111 S.Ct. 2173, 2179-2180; see SEA § 16(b) (15 USC § 78p(b)); *Grosset v. Wenaas* (2008) 42 C4th 1100, 1116-1117, 72 CR3d 129, 142-143; *and ¶ 6:379 ff.*]

(c) [6:618] **Continued ownership required throughout litigation:** Plaintiff must remain a shareholder for the duration of the derivative proceeding. [Corps.C. § 800(b)(1)—“No action may be instituted *or maintained* in right of any domestic or foreign corporation by any holder of shares …” (emphasis added); Corps.C. § 2900(d)(1) (SPCs); *Grosset v. Wenaas* (2008) 42 C4th 1100, 1114-1115, 1119, 72 CR3d 129, 141, 145; *Heckmann v. Ahmanson* (1985) 168 CA3d 119, 129, 214 CR 177, 184—by voluntarily selling stock back to corporation as part of “greenmail” transaction (¶ 7:134), plaintiff-shareholder lost standing to prosecute then-pending derivative action; see also *Villari v. Mozilo* (2012) 208 CA4th 1470, 1479, 146 CR3d 556, 562, fn. 9—continuous ownership requirement is “internal affair” governed by foreign corporation's state of incorporation (*see ¶ 3:4.1 ff.*); compare *Turner v. Victoria* (2023) 15 C5th 99, 125, 134, 311 CR3d 44, 60, 67 (distinguishing *Grosset*, supra)—director of charitable corporation does not lose status to maintain director enforcement action under Corps.C. §§ 5142, 5233, or 5223 even if they lose director position after commencing action]

1) [6:618.1] **Same rule in federal court actions:** A plaintiff in a derivative suit brought in federal court—whether based on federal question or diversity jurisdiction—must likewise remain a shareholder throughout the litigation. [See *Quinn v. Anvil Corp.* (9th Cir. 2010) 620 F3d 1005, 1012-1014—reverse stock split and payoff of plaintiff's resulting fractional share deprived plaintiff of standing to pursue derivative action; *Kona Enterprises, Inc. v. Estate of Bishop* (9th Cir. 1999) 179 F3d 767, 769; *Lewis v. Chiles* (9th Cir. 1983) 719 F2d 1044, 1047]

2) [6:618.2] **Ordinarily, no exception for involuntary sale of stock:** A derivative plaintiff who loses their stock through an involuntary sale (e.g., incident to merger) likewise loses standing to prosecute the derivative action. Plaintiffs who are divested of their shares involuntarily have no greater interest in the potential recovery or in the continued wellbeing of the corporation than plaintiffs who willingly sell their shares. [*Grosset v. Wenaas* (2008) 42 C4th 1100, 1116, 72 CR3d 129, 142; compare *Gollust v. Mendell* (1991) 501 US 115, 126-127, 111 S.Ct. 2173, 2181—plaintiff suing to recover short-swing profits from insider trading (SEA § 16(b) (15 USC § 78p(b)), *¶ 6:376 ff.*) not thwarted by postcomplaint merger replacing plaintiff's stock for stock in new corporate parent]

a) [6:618.3] **Effect on recovery of shareholder's litigation expenses:** A derivative plaintiff is entitled to recover attorney fees and litigation expenses only if their efforts resulted in a monetary recovery for, or otherwise conferred a substantial benefit on, the corporation (*see ¶ 6:668*). This rule is not changed by an involuntary (or voluntary) stock sale that occurs during the derivative action. “Where a corporation's actions vitiating a derivative suit have a legitimate business purpose, there is no basis for requiring that the shareholders bear a proportion of a plaintiff's

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

costs if the suit has not yielded a benefit to the corporation." [*Grosset v. Wenaas* (2008) 42 C4th 1100, 1118-1119, 72 CR3d 129, 144 (quoting *Lewis v. Chiles*, supra, 719 F2d at 1049)]

b) [6:619] **Potential exception for sham forced buy-out:** The *Grosset* Court indicated that equitable considerations may warrant an exception to the continuous ownership requirement where, e.g., a merger either is used as a fraud to wrongfully deprive a derivative plaintiff of standing or is merely a reorganization that does not affect plaintiff's ownership interest. [*Grosset v. Wenaas* (2008) 42 C4th 1100, 1119, 72 CR3d 129, 145; see *Villari v. Mozilo* (2012) 208 CA4th 1470, 1479-1485, 146 CR3d 556, 562-568 (applying Del. law)]

[6:619.1 - 6:619.4] ***Reserved.***

(d) [6:619.5] **Action by shareholder of dissolved corporation:** A dissolved corporation continues to exist for the purpose of winding up its affairs, including prosecuting and defending litigation (*see ¶ 8:995*). Further, a dissolved corporation's shareholders do not cease to exist as shareholders; indeed, they stand to benefit from any income or assets the corporation may acquire after dissolution, including any recovery pursued for the corporation's benefit. Thus, dissolution itself does not deprive a shareholder of standing to bring a derivative action. [*Favila v. Katten Muchin Rosenman LLP* (2010) 188 CA4th 189, 212-217, 115 CR3d 274, 292-297 (derivative action by deceased shareholder's estate); see *Reilly v. Greenwald & Hoffman, LLP* (2011) 196 CA4th 891, 901-902, 127 CR3d 317, 324-325]

(e) [6:620] **Controlling shareholder and corporation disqualified:** The contemporaneous shareholder requirement clearly bars a derivative suit against former management by a *controlling shareholder* who purchased their shares *after* the alleged wrongdoing.

Moreover, although no California authority so holds, equitable considerations may bar such a controlling shareholder from compelling the *corporation* to bring a direct action against former management. Reason: If the controlling shareholder knew of the alleged wrongful conduct and took it into account in negotiating the purchase price of the shares, they would reap a *windfall* if the corporation brings suit and obtains damages for the same wrongful conduct. If the controlling shareholder claims they did *not* know of the wrongful conduct before purchasing the shares and were defrauded by the seller, a direct action for fraud, securities violations, etc. should be brought. [See *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co.* (1974) 417 US 703, 711-713, 94 S.Ct. 2578, 2583-2584—action by corporation barred where 98.3% of shares purchased from alleged wrongdoer after alleged wrongdoing]

(f) [6:620a] **Must "adequately represent" other shareholders (federal actions):** To maintain a derivative suit brought under *federal* law (e.g., federal securities statutes), the plaintiff shareholder must *fairly and adequately represent* the interests of similarly situated shareholders. [FRCP 23.1]

In determining the adequacy of a derivative plaintiff's representation, courts consider the following factors:

• Indications plaintiff is not the true party in interest;

• Plaintiff's unfamiliarity with the suit and unwillingness to learn about it;

• Degree of control exercised by attorneys over the suit;

• Degree of support received by plaintiff from other shareholders;

• Plaintiff's lack of personal commitment to the action;

• Remedy sought;

• Relative magnitude of plaintiff's *other personal* interests compared to their interest in the derivative suit itself; and

• Plaintiff's vindictiveness toward defendants. [*Larson v. Dumke* (9th Cir. 1990) 900 F2d 1363, 1367]

1) [6:620.1] **Shareholder with individual claims against corporation disqualified:** In a suit governed by federal law, a shareholder pursuing personal litigation against a corporation ordinarily will not qualify to serve as the "representative" plaintiff who must "*fairly and adequately*" represent the other shareholders (per FRCP 23.1) in the derivative suit. [*Zarowitz v. Bank-America Corp.* (9th Cir. 1989) 866 F2d 1164, 1166]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Indeed, such a shareholder will also lack standing to object to settlement of the shareholders' derivative action (*see* *¶ 6:667.1*).

(2) [6:621] **Compare—direct action by former shareholders:** Former shareholders ordinarily cannot maintain direct or derivative suits. However, where management's wrongdoing diminished the value of the shares sold, a former shareholder may bring a direct action to recover the loss in value. But the former shareholder must show that (i) they sold the shares *without knowledge* of such wrongdoing; and (ii) the wrong would otherwise go unremedied. [*Watson v. Button* (9th Cir. 1956) 235 F2d 235, 237 (applying Oregon law)]

c. [6:622] **Demand on board of directors prior to filing suit:** A shareholder cannot initiate a derivative suit without first informing the directors about the action and making a reasonable effort to induce them to commence suit themselves or otherwise redress the wrong, unless such efforts would be "useless" or "futile" (¶ 6:626 ff.). [Corps.C. § 800(b)(2); *Kanter v. Reed* (2023) 92 CA5th 191, 204, 309 CR3d 375, 383 (*discussed at* ¶ 6:247); *Schrage v. Schrage* (2021) 69 CA5th 126, 156, 284 CR3d 279, 305, fn. 14 (quoting text); see also Corps.C. § 2900(d)(2) (SPCs)]

(1) [6:623] **Demand must identify shareholder:** Federal and Delaware courts have held that the shareholder must be identified in the demand. Thus, a demand made by an attorney on behalf of unidentified shareholders is not valid. And where the demand identifies only some of the shareholders making the demand, the demand will not be valid as to any unidentified shareholders who subsequently attempt a derivative action. "The identity of the complaining shareholder may shed light on the veracity or significance of the facts alleged in the demand letter, and the Board might properly take a different course of action depending on the shareholder's identity." [*Potter v. Hughes* (9th Cir. 2008) 546 F3d 1051, 1056-1058 (case arose under federal law but court relied on Delaware law and noted California law is identical to Delaware law on demand requirement); *Smachlo v. Birkelo* (D DE 1983) 576 F.Supp. 1439, 1444]

(2) [6:624] **Pleading requirements:** The complaint must allege "with *particularity* plaintiff's efforts to secure from the board such action as plaintiff desires, or the *reasons* for *not* making such effort." [Corps.C. § 800(b)(2) (emphasis added); see also Corps.C. § 2900(d)(2) (SPCs)]

Plaintiff must also allege that they have:

- *Informed* the corporation (or the board) in writing of the ultimate facts of each cause of action to be asserted against each defendant; *or*
- *Delivered* to the corporation (or the board) a true copy of plaintiff's proposed complaint. [Corps.C. § 800(b)(2); see also Corps.C. § 2900(d)(2) (SPCs)]

[6:625] ***Reserved.***

(3) [6:625.1] **Board rejection of demand:** The propriety of a board's decision to *reject* a shareholder demand is tested by the "business judgment rule"; *see* *¶ 6:630 ff.*

(4) [6:626] **Demand excused when futile:** Plaintiff is excused from trying to obtain relief from the board if they can show such efforts would have been "futile" or "useless." [*Bader v. Anderson* (2009) 179 CA4th 775, 789-790, 101 CR3d 821, 832-833; *Gottesfeld v. Richmaid Ice Cream Co.* (1953) 115 CA2d 854, 860, 252 P2d 973, 978; see *Grosset v. Wenaas* (2008) 42 C4th 1100, 1107, 72 CR3d 129, 135, fn. 4]

(a) [6:626.1] **Pleading of specific facts required:** The complaint must allege *specific facts* as to *each director* showing why demand would be futile. General allegations "relating to the structural bias common to corporate boards throughout America," or that the directors were ultimately accountable for corporate employees' wrongdoing, or that the directors were involved in a conspiracy or aided and abetted the wrongful acts, are insufficient. [See *Kanter v. Reed* (2023) 92 CA5th 191, 205, 309 CR3d 375, 384 (*discussed at* ¶ 6:247); *Bader v. Anderson* (2009) 179 CA4th 775, 790, 101 CR3d 821, 833; *Apple Inc. v. Sup.Ct. (Police Retirement System of St. Louis)* (2017) 18 CA5th 222, 232-233, 253, 227 CR3d 8, 15, 32; *Oakland Raiders v. National Football League* (2001) 93 CA4th 572, 587, 113 CR2d 255, 267; *Leyte-Vidal v. Semel* (2013) 220 CA4th 1001, 1007-1011, 163 CR3d 641, 646-649 (applying Del. law)]

1) [6:626.2] **No discovery to prove futility:** Where defendant properly challenges plaintiff's failure to allege demand futility, plaintiff is not entitled to conduct discovery seeking evidence to refute the challenge. A showing that demand was sought or would be futile is a *prerequisite* to *maintaining* the action. "The proper purpose of discovery in a

shareholder derivative action is to find out additional facts about a well-pleaded claim, not to find out whether such a claim exists." [*Jones v. Martinez* (2014) 230 CA4th 1248, 1254-1255, 179 CR3d 35, 39 (decided under Del. law, but same principle would appear to apply under Calif. law)]

(b) [6:626.3] **Test for futility in challenging board action:** In actions challenging conscious decisions by the board to act or refrain from acting, a plaintiff claiming demand futility must show particularized facts creating a *reasonable doubt* that:

- The directors are *disinterested* in and *independent* of the challenged transaction; *or*

- The challenged transaction was otherwise the product of a valid exercise of *business judgment*. [See *Kanter v. Reed* (2023) 92 CA5th 191, 205, 309 CR3d 375, 384 (*discussed at* ¶ 6:247); *Charter Township of Clinton Police & Fire Retirement System v. Martin* (2013) 219 CA4th 924, 935-940, 162 CR3d 300, 309-313; *Bader v. Anderson* (2009) 179 CA4th 775, 791, 797, 101 CR3d 821, 833-834, 838-839 (adopting commonly employed "2-prong" test first enunciated by Del. courts); *Apple Inc. v. Sup.Ct. (Police Retirement System of St. Louis)* (2017) 18 CA5th 222, 233, 227 CR3d 8, 15-16 (same)]

This test is disjunctive: Demand is *excused* if *either prong is satisfied*. [*Charter Township of Clinton Police & Fire Retirement System v. Martin*, supra; *Bader v. Anderson*, supra]

1) [6:626.4] **Alternative test where no board action:** The above test (¶ 6:626.3) does not work well where there was no board action, such as where the challenged business decision was (i) *not* a *board* decision, (ii) made by the board of a *different* corporation, or (iii) made by a board, the majority of whose directors are *no longer directors* when the suit is filed. In these circumstances, the inquiry is whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations (i.e., to show demand futility, plaintiff must allege facts creating a *reasonable doubt* the board of directors could have properly exercised its *independent and disinterested business judgment* in responding to a demand). [See *Bader v. Anderson* (2009) 179 CA4th 775, 791-792, 797, 101 CR3d 821, 834, 838 (adopting test employed by Del. courts); *Kanter v. Reed* (2023) 92 CA5th 191, 205, 309 CR3d 375, 384-385 (*discussed at* ¶ 6:247); *Apple Inc. v. Sup.Ct. (Police Retirement System of St. Louis)* (2017) 18 CA5th 222, 233, 243, 227 CR3d 8, 16, 24]

2) [6:626.4a] **Compare—Delaware test for assessing demand futility:** In cases where Delaware law applies, courts must determine (on a "director-by-director basis"): (i) whether the director received a "material personal benefit" from the alleged misconduct that is the subject of the litigation; (ii) whether the director faces a "substantial likelihood of liability" on any of the claims; or (iii) whether the director "lacks independence" from someone who received a material personal benefit from the alleged misconduct or who faces a substantial likelihood of liability. "If the answer to any of the questions is 'yes' for at least half of the members of the demand board, then demand is excused as futile." [*United Food & Comm'l Workers Union & Participating Food Indus. Employers Tri-State Pension Fund v. Zuckerberg* (Del. 2021) 262 A3d 1034, 1059; *Tola v. Bryant* (2022) 76 CA5th 746, 752-755, 291 CR3d 728, 732-735 (applying Delaware law)—plaintiff failed to allege particularized facts that majority of board faced substantial likelihood of liability for failing to implement system of controls to report cybersecurity issues]

3) [6:626.5] **"Disinterested":** A director is *not* "disinterested" if the alleged facts demonstrate a *potential personal benefit* or *detriment* to the director as a result of the challenged transaction (other than a benefit or detriment shared in common with the corporation or its shareholders). [*Bader v. Anderson* (2009) 179 CA4th 775, 792, 101 CR3d 821, 834; *Apple Inc. v. Sup.Ct. (Police Retirement System of St. Louis)* (2017) 18 CA5th 222, 254, 227 CR3d 8, 32; *see* ¶ *6:286 ff.*]

a) [6:626.6] **Director's potential liability as excusing demand:** The fact that a director may face potential personal liability in challenging a transaction they previously approved does not itself create a reasonable doubt that the director is "disinterested." However, "in rare cases a transaction may be so egregious on its face" that a "substantial likelihood" of liability exists and hence demand would be deemed futile. [*Charter Township of Clinton Police & Fire Retirement System v. Martin* (2013) 219 CA4th 924, 936, 162 CR3d 300, 309-310; *see also* ¶ *6:627.1*]

4) [6:626.7] **"Independent":** A director is not "independent" if the alleged facts cast *reasonable doubt* that the director's decision was based on the *corporate merits* of the challenged transaction rather than on extraneous considerations or influences. [*Bader v. Anderson* (2009) 179 CA4th 775, 792, 101 CR3d 821, 834]

a) [6:626.8] **Board dominated by wrongdoing directors or controlling shareholder:** Directors are not "independent," and hence demand on the board may be excused, where the directors are dominated by a controlling shareholder, or where the wrongdoing was committed by a director who so dominated the board that it would be "inconceivable" that any demand would result in corporate action against the dominant director. [*Bader v. Anderson* (2009) 179 CA4th 775, 792, 101 CR3d 821, 834; *Reed v. Norman* (1957) 152 CA2d 892, 898, 314 P2d 204, 207; see *Country Nat'l Bank v. Mayer* (ED CA 1992) 788 F.Supp. 1136, 1146 (applying Calif. law)]

Simple allegations that a controlling shareholder personally selected the directors, or that a director has a personal friendship or outside business relationship with the controlling shareholder or dominant director, will not show lack of independence. Rather, plaintiff must present specific facts showing a relationship so substantial that a director would be more willing to *risk their reputation* than the relationship with the controlling shareholder or dominant director. [*Bader v. Anderson*, supra, 179 CA4th at 792, 101 CR3d at 834-835]

5) [6:626.9] **Demand not excused where action alleges violation of federal proxy rules:** A derivative claim alleging directors violated federal proxy rules by making misleading communications to shareholders is not per se exempt from the demand requirement. This is so whether the action is brought under federal securities laws or in the form of a state law breach of fiduciary duty claim. Although there is some disagreement on this issue, a California court, following the weight of authority, held that directors' false or misleading statements in proxy materials involve the valid exercise of *business judgment* (*see ¶ 6:626.3*). [See *Bader v. Anderson* (2009) 179 CA4th 775, 794-796, 101 CR3d 821, 836-838; see also *Charter Township of Clinton Police & Fire Retirement System v. Martin* (2013) 219 CA4th 924, 936-937, 162 CR3d 300, 310-311—conclusory allegations that directors "issued" proxy statement and signed SEC filing containing false statements related to proxy were insufficient to show demand futility; *and ¶ 6:628*]

6) [6:627] **Majority of board involved in wrongdoing:** Demand on the board would clearly be futile where a *majority* of the directors are alleged to have been involved in the wrongful conduct. Here, a demand on the board would in effect be a request to the directors that they sue themselves. [See *Reed v. Norman* (1957) 152 CA2d 892, 898, 314 P2d 204, 207; and *Gottesfeld v. Richmaid Ice Cream Co.* (1953) 115 CA2d 854, 860, 252 P2d 973, 978]

a) [6:627a] **Series of interested director transactions—majority need not participate in each transaction:** Where plaintiff alleges a series of self-dealing transactions between the corporation and interested directors, it is *not* necessary to implicate a majority in each transaction. Demand is excused as futile if plaintiff alleges a reciprocal pattern or understanding among a majority of directors to engage in the *overall series* (i.e., "you approve my transaction and I'll approve yours"). [See *Country Nat'l Bank v. Mayer* (ED CA 1992) 788 F.Supp. 1136, 1146 (applying Calif. law)]

7) [6:627.1] **Compare—directors not accused of wrongdoing:** Where the directors merely approved or benefited from the challenged acts, but are not themselves alleged wrongdoers or potential defendants, their involvement does *not* excuse making a demand—i.e., a demand would not imply "that the directors should go sue themselves." [See *Charter Township of Clinton Police & Fire Retirement System v. Martin* (2013) 219 CA4th 924, 935-936, 162 CR3d 300, 309-310; *Bader v. Anderson* (2009) 179 CA4th 775, 792-793, 101 CR3d 821, 835; *Potter v. Hughes* (9th Cir. 2008) 546 F3d 1051, 1058-1059; *see also ¶ 6:626.6*]

(c) [6:627.2] **Futility determined as of date of complaint:** Futility is generally measured as of the time the derivative action is filed. [*Apple Inc. v. Sup.Ct. (Police Retirement System of St. Louis)* (2017) 18 CA5th 222, 231, 243, 227 CR3d 8, 14, 23]

Where the composition of the board changes after plaintiff commences the action and plaintiff files an *amended* complaint, plaintiff may be required to demonstrate futility as of the date of the amended complaint. This requirement does *not* apply to an amendment that *elaborates* upon facts relating to acts or transactions alleged in the original pleading, or asserts new legal theories of recovery *based upon the acts or transactions that formed the substance of the original pleading*. The requirement applies only if the trial court deemed the complaint *legally insufficient* either for *failure to state a claim* or *failure to meet the demand requirement*. [*Apple Inc. v. Sup.Ct. (Police Retirement System of St. Louis)*, supra, 18 CA5th at 231, 246-247, 251, 227 CR3d at 14, 26, 30]

(d) [6:628] **Derivative claims brought in federal court:** In a derivative action brought in federal court, applicable *state law* (specifically, the law of the state of *incorporation*) determines the need for a shareholder derivative plaintiff to make a presuit demand on the corporation's board of directors. This is so whether federal jurisdiction is based on diversity or

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a federal statute (e.g., federal securities laws). [See FRCP 23.1; *Kamen v. Kemper Fin'l Services, Inc*. (1991) 500 US 90, 97-98, 111 S.Ct. 1711, 1716-1717—in derivative action under Investment Company Act of 1940, Supreme Court rejected 7th Circuit rule that abolished "futility exception" to demand requirement and would have required "universal demand" in federal derivative suits; *Towers v. Iger* (9th Cir. 2018) 912 F3d 523, 528, fn. 4; *Arduini v. Hart* (9th Cir. 2014) 774 F3d 622, 628; also see Stevenson & Fitzgerald, *Rutter Group Prac. Guide: Federal Civ. Pro. Before Trial* (TRG), Ch. 10; *and ¶ 6:626.9*]

(e) [6:629] **Board appointment of special litigation committee as excusing demand:** Appointment of a special litigation committee (*¶ 6:634*) *before* making a motion to dismiss for failure to make a demand gives rise to an inference that the board has conceded its involvement (*¶ 6:627*), thus making a demand unnecessary. In contrast, no such inference may be drawn if the committee is appointed *after* the motion is made. [See *Apple Inc. v. Sup.Ct. (Police Retirement System of St. Louis)* (2017) 18 CA5th 222, 239, 227 CR3d 8, 21; *Abbey v. Computer & Communications Tech. Corp.* (Del.Ch. 1983) 457 A2d 368, 374; *Peller v. Southern Co.* (11th Cir. 1990) 911 F2d 1532, 1537-1538 (applying Del. law); but see *Spiegel v. Buntrock* (Del. 1990) 571 A2d 767, 776-777—appointment of special litigation committee does not automatically subject board's action to enhanced scrutiny]

➪ [6:629.1] ***PRACTICE POINTER:*** To avoid an inference of director involvement, counsel should consider recommending that appointment of a special litigation committee be deferred until after filing a motion to dismiss on grounds that no demand was made. (In any event, a properly constituted special litigation committee retains the power to obtain dismissal of the derivative claims; *see ¶ 6:634 ff.*)

[6:629.2 - 6:629.4] ***Reserved.***

(5) [6:629.5] **Defendant can raise failure to make demand:** Plaintiff's unexcused failure to make a demand presumably can be raised either by the corporation or by the third party ("outside") defendants against whom the suit is brought. [See *Kaplan v. Peat, Marwick, Mitchell & Co*. (Del.Ch. 1987) 529 A2d 254, 258, rev'd on other grounds (Del. 1988) 540 A2d 726, 727]

d. Directors' discretion to bar suit

(1) [6:630] **Rejecting shareholder demand:** The complaining shareholder is barred from maintaining a derivative suit if a *disinterested majority* of the board makes a *good faith business judgment* that the action is not in the corporation's best interests and thus rejects the shareholder's demand that the corporation institute suit (¶ 6:622 ff.).

This is so even if plaintiff shows the corporation would probably obtain a substantial recovery from the suit, or the board's decision is otherwise viewed as "mistaken." Reason: So long as they use their best business judgment, the directors—not the shareholders—are entitled to control the corporation. [*Findley v. Garrett* (1952) 109 CA2d 166, 174-175, 240 P2d 421, 426; see also *Beehan v. Lido Isle Comm. Ass'n* (1977) 70 CA3d 858, 866, 137 CR 528, 532]

(a) [6:631] **Good faith business judgment required:** As stated above, the board's decision must constitute a good faith business judgment—in other words, it must be entitled to the protection of the business judgment rule (*¶ 6:245*).

1) [6:632] **Independent majority:** This means the decision must be made by an independent majority of board members who were not financially or otherwise interested in the challenged transaction, whether or not they approved it. [See *Findley v. Garrett* (1952) 109 CA2d 166, 174-175, 240 P2d 421, 426]

A director is "interested" only if the complaint alleges specific facts showing actual participation in, or concealment of, the alleged wrongdoing. [See *Findley v. Garrett*, supra; *Burt v. Irvine Co.* (1965) 237 CA2d 828, 848-849, 47 CR 392, 405; also see *Charter Township of Clinton Police & Fire Retirement System v. Martin* (2013) 219 CA4th 924, 936, 162 CR3d 300, 309-310; *In re Oracle Corp. Derivative Litig.* (Del.Ch. 2003) 824 A2d 917, 939-948]

a) [6:633] **Insider trading violations:** Where the suit is on behalf of a public corporation seeking treble damages under California law, and the demand alleges that any director has been involved in insider trading violations (see Corps.C. § 25402; *¶ 6:382 ff.*), such director may not vote on the matter (but may be counted toward a quorum). [Corps.C. § 25502.5(c)]

2) [6:633.1] **Reasonable investigation:** In addition, the board must conduct a reasonable investigation of the facts. [*Burt v. Irvine Co.* (1965) 237 CA2d 828, 852-853, 47 CR 392, 408; *¶ 6:246*]

➪ [6:633.2] ***PRACTICE POINTER:*** The directors should make a *record* (e.g., board or committee minutes) reflecting their diligent efforts to become *fully informed* (i.e., through legal, accounting and other advice).

3) [6:633.2a] **Reliance upon counsel who also represented alleged wrongdoers:** In a case applying Delaware law, a board's decision to reject a shareholder demand to bring suit against insider directors was *denied* business judgment rule protection where the decision was influenced by corporate counsel who had previously represented the inside directors in a related criminal proceeding.

The board acted improperly in delegating to such counsel the board's duty to investigate; counsel's *conflict of interest* rendered the board's expectation of a thorough investigation "unreasonable and, in fact, grossly negligent." And counsel's intense involvement in the board meeting at which the decision was made created a reasonable doubt that the board validly exercised its business judgment in rejecting the shareholder's demand. [*Stepak v. Addison* (11th Cir. 1994) 20 F3d 398, 404, 406]

4) [6:633.3] **"Cost-benefit" analysis:** In making its decision, the board should weigh the probability of recovery and the advantages that may thereby be obtained "against the cost in money, time and disruption of the business of the company which litigation would entail." [*Findley v. Garrett* (1952) 109 CA2d 166, 177, 240 P2d 421, 428]

(2) [6:634] **Dismissal by special litigation committee:** As stated above (*¶ 6:627*), if a majority of the board is charged with wrongdoing, no demand need be made and the complaining shareholders can proceed directly with a derivative suit.

Nevertheless, an "interested" board majority may *delegate* to a *disinterested* "special litigation committee" the business judgment authority to bar a derivative suit. Reason: Corps.C. § 311 authorizes the board to delegate "all" of its authority (except as specified, *¶ 6:181 ff.*). Thus, the board may delegate to a special committee what it is deemed unable to do itself. [*Desaigoudar v. Meyercord* (2003) 108 CA4th 173, 184-186, 133 CR2d 408, 416-417; *Finley v. Sup.Ct. (Third Laguna Hills Mutual)* (2000) 80 CA4th 1152, 1158-1162, 96 CR2d 128, 132-135; see *Zapata Corp. v. Maldonado* (Del. 1981) 430 A2d 779, 784-787—"interest taint" of board majority does not per se bar delegation to independent committee composed of 2 disinterested directors]

[6:635] ***Reserved.***

(a) [6:636] **Dismissal required if committee exercised good faith business judgment:** A derivative suit must be dismissed if a special litigation committee makes a good faith business judgment that the action should be terminated because it is unmeritorious and/or not in the corporation's best interests. In ruling on the dismissal motion, the court may *not* consider the merits of plaintiff's derivative claim; rather, the court is limited to determining if there is a factual dispute over whether the committee members:

• Were *disinterested* and *independent;* and

• Conducted an *adequate investigation* of the claims raised in the suit. [*Desaigoudar v. Meyercord* (2003) 108 CA4th 173, 185-190, 133 CR2d 408, 416-420; *Finley v. Sup.Ct. (Third Laguna Hills Mutual)* (2000) 80 CA4th 1152, 1160-1161, 96 CR2d 128, 132, 134; see *Bezirdjian v. O'Reilly* (2010) 183 CA4th 316, 322-328, 107 CR3d 384, 391-395—complaining shareholder desiring to avoid dismissal has burden of showing committee did not exercise good faith business judgment in rejecting demand (decided under Del. law)]

1) [6:637] **Independence of committee members:** The special litigation committee must be comprised of two or more directors who do not benefit financially or otherwise from the challenged transaction. A director is apparently not disqualified from serving on the committee where they are named as a defendant but *did not benefit* from the challenged transaction. [See *Lewis v. Anderson* (9th Cir. 1979) 615 F2d 778, 781-783 (applying Calif. law); also see *Desaigoudar v. Meyercord* (2003) 108 CA4th 173, 189, 133 CR2d 408, 419-420]

The committee members should also have no significant personal, family, professional or economic relationships with those defendant directors who *did benefit* from the challenged transaction. "At bottom, the question of independence turns on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind." [*In re Oracle Corp. Derivative Litig.* (Del.Ch. 2003) 824 A2d 917, 938 (emphasis in original); see *Kahn v. Tremont Corp.* (Del. 1997) 694 A2d 422, 428-430]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [6:638] **Appointment of additional directors:** Some boards confronted with derivative actions involving most or all of their members have appointed additional directors who were uninvolved in the challenged transaction to comprise the special litigation committee. [See *Will v. Engebretson & Co., Inc.* (1989) 213 CA3d 1033, 1036, 261 CR 868, 869]

2) [6:639] **Investigation:** Special outside legal counsel are often retained to assist special litigation committees with the investigation.

➪ [6:639.1] ***PRACTICE POINTER:*** The committee members should be *actively involved* in supervising the factual investigation. Upon completion of such investigation, they, and not legal counsel, should make the ultimate decision whether the lawsuit is in the corporation's best interests. The committee's investigation and deliberations should be *fully documented* in the corporate records.

3) [6:639.2] **"Cost-benefit" analysis:** In making its decision, the committee should conduct a "cost-benefit" analysis of the various factors involved. [See *Findley v. Garrett* (1952) 109 CA2d 166, 177-178, 240 P2d 421, 428, *discussed at ¶ 6:633.3*; and see, e.g., *Joy v. North* (2nd Cir. 1982) 692 F2d 880, 892 (subsequently overruled by Conn. Gen. Stats. Ann. § 33-724)]

4) [6:639.3] **No discovery of committee report or materials:** In a case arising under Delaware law, a California appellate court held that the complaining shareholder does not have a right to conduct discovery into the committee's report or the materials the committee relied on in refusing the shareholder's demand. At least this is so absent sufficient factual allegations showing the committee did not exercise good faith business judgment in rejecting the demand. [*Bezirdjian v. O'Reilly* (2010) 183 CA4th 316, 326-328, 107 CR3d 384, 394-395]

The court went on to state that the shareholder's right to inspect corporate records under former Corps.C. § 1601 (*¶ 6:506 ff.*) did not create such a discovery right. [*Bezirdjian v. O'Reilly*, supra, 183 CA4th at 328, 107 CR3d at 395-396 (noting also that shareholder failed to pursue § 1601 inspection rights prior to filing suit)]

(b) [6:640] **Compare—other states:** Courts in some states (including Delaware) will not dismiss a derivative suit merely because a special litigation committee recommends in good faith that it be terminated. These courts will dismiss the suit only if:

• [6:641] The committee's recommendation constitutes a good faith exercise of business judgment (i.e., was made by disinterested directors in good faith on an informed basis); *and*

• [6:642] In the *independent judgment* of the *court*, the action is *not* in the corporation's best interests. [See *Houle v. Low* (Mass. 1990) 556 NE2d 51, 58-59; *Alford v. Shaw* (N.C. 1987) 358 SE2d 323, 328; *Biondi v. Scrushy* (Del.Ch. 2003) 820 A2d 1148, 1164 & fn. 40, aff'd (Del. 2004) 820 A2d 1148; *In re PSE & G Shareholder Litig.* (N.J.Ch. 1998) 718 A2d 254, 260-261, aff'd (NJ 2002) 802 A2d 295]

1) [6:642.1] **Comment:** The court in *Desaigoudar v. Meyercord*, supra, explicitly rejected this second step, concluding that any structural bias (i.e., the inclination of directors—even independent director—to close ranks and protect their fellow directors out of group loyalty) can be addressed when a court scrutinizes the independence of the special litigation committee members and the reasonableness of their decision-making process (¶ 6:636). [*Desaigoudar v. Meyercord* (2003) 108 CA4th 173, 184-190, 133 CR2d 408, 416-420]

e. [6:643] **Security for defendants' expenses:** The court may require the plaintiff in a derivative suit to furnish a bond to secure reimbursement of reasonable litigation expenses incurred by management-defendants (and the corporation itself) if plaintiff loses the suit. [Corps.C. § 800(c); see also Corps.C. § 2900(e) (SPCs)]

(*Compare:* There is no similar requirement imposed upon a plaintiff-shareholder in a *direct* action, whether it is brought individually or on behalf of a class; *¶ 6:599*.)

(Note re SPCs: The reference in Corps.C. § 2900(e) to "subdivision (c)" is a legislative typo; the reference should be to "subdivision (d).")

➪ [6:643.1] ***PRACTICE POINTER:*** A successful motion for security is a relatively inexpensive and expeditious method for management to encourage a plaintiff-shareholder to abandon an unmeritorious derivative suit. This is because the plaintiff can be required to furnish security if the judge finds there is "no reasonable possibility" the suit will benefit the corporation, and/or one or more named defendants was not involved in the challenged transaction (and therefore not liable) (*¶ 6:649 ff.*). Most plaintiffs will have second thoughts about pursuing the litigation after a judge has made such findings. Indeed, experience indicates that most derivative plaintiffs dismiss the suit rather than post a bond.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [6:644] **Who may require security:** Only the following persons or entities are entitled to require plaintiff to post security for their litigation expenses:

• The corporation itself;

• The officers or directors of the corporation; and

• The *former* corporate officers or directors if they held office at the time of the acts complained of. [Corps.C. § 800(c); see also Corps.C. § 2900(e) (SPCs)]

Thus, *third-party* defendants are *not* entitled to such security.

(2) [6:645] **Who must post security:** *Any* plaintiff-shareholder may be required to furnish the security. There is no exception even for plaintiffs holding a substantial share interest in the corporation. [*Wood v. Gordon* (1952) 112 CA2d 374, 377-378, 246 P2d 84, 86—security requirement not intended to apply only to suits brought by nominal shareholders solely to obtain attorney fees ("strike suits"); *Suburban Water Systems v. Sup.Ct.* (1968) 264 CA2d 956, 961, 71 CR 45, 48]

(a) [6:646] **Exception for shareholder-intervenor in involuntary dissolution proceeding:** However, a shareholder intervening in an involuntary dissolution proceeding (Corps.C. § 1800; *¶ 8:816*) is *not* subject to the security requirement, even though they assert rights of action the corporation may have against its directors and officers. Reason: The protection of Corps.C. § 800 is not required because the court has broad supervisory powers in such proceedings, and can order that the parties be reimbursed for litigation expenses. [*Hagan v. Sup.Ct. (Fairfield)* (1960) 53 C2d 498, 503, 2 CR 288, 291]

(3) [6:646.1] **Court order must be obtained:** To require such security, the corporation or one or more defending directors or officers must bring a noticed motion for a court order.

(a) [6:647] **Time for motion:** The motion may be brought anytime within 30 days after service of summons and complaint on the moving parties. The court may extend this period up to 60 days for good cause. [Corps.C. § 800(c); see also Corps.C. § 2900(e) (SPCs)]

(b) [6:648] **Effect of filing motion:** The filing of such a motion by defendants entitled to do so (¶ 6:644) stays all further proceedings (including discovery) until 10 days after the motion is disposed of. No further pleadings need be filed by the corporation or any other defendant (including third parties) until the stay expires. [Corps.C. § 800(f); see also Corps.C. § 2900(h) (SPCs)]

(Note re SPCs: The reference in Corps.C. § 2900(h) to "subdivision (d)" is a legislative typo; the reference should be to "subdivision (e).")

(c) [6:649] **Grounds for motion:** The motion for security may be based on one or both of the following grounds:

1) [6:650] **No "reasonable possibility" suit will benefit corporation:** Plaintiff must furnish the moving party with security if the moving party establishes "a probability" that there is *no* "reasonable possibility" that prosecuting the cause of action against the moving defendant will benefit the corporation or its shareholders. [Corps.C. § 800(c)(1); see also Corps.C. § 2900(e)(1) (SPCs); and *Donner Mgmt. Co. v. Schaffer* (2006) 142 CA4th 1296, 1304, 48 CR3d 534, 538—assessment of reasonable possibility of corporate benefit (*¶ 6:650*) requires court to evaluate possible defenses that plaintiff must overcome to prevail at trial]

a) [6:651] **Application unclear:** It is unclear how this test is to be applied:

• One case holds that the test is met where "the plaintiff's chances of success are slight." [*Marble v. Latchford Glass Co.* (1962) 205 CA2d 171, 175, 22 CR 789, 791]

• However, another court indicated that security may be required where there is a "reasonable possibility" that *defendant* will prevail. [*Burt v. Irvine Co.* (1965) 237 CA2d 828, 868, 47 CR 392, 418, fn. 5]

A sensible reading of the requirement that the moving party establish "a probability" that "there is no reasonable possibility" that the claim will benefit the corporation or its shareholders is that the court must find it is *more likely than not* that the claim will *not benefit the corporation or its shareholders*.

2) [6:652] **Moving party not a participant in challenged transaction:** The other ground for requiring security is that the moving defendant (if other than the corporation) did not participate in the challenged transaction in any capacity. [Corps.C. § 800(c)(2); see also Corps.C. § 2900(e)(2) (SPCs)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(d) [6:653] **Burden of proof on moving party:** The moving party bears the burden of proof: They must establish a "*probability*" in support of any of the grounds on which the motion is based (¶ 6:649 ff.). [Corps.C. § 800(d); see also Corps.C. § 2900(f) (SPCs)]

(e) [6:654] **Hearing on motion:** At the hearing on the motion, the court will consider all oral or written evidence (whether by testimony or affidavit) that is material to (i) the grounds on which the motion is based, and (ii) determining the probable litigation expenses of the corporation and moving defendant. [Corps.C. § 800(d); see also Corps.C. § 2900(f) (SPCs)]

(Note re SPCs: The reference in Corps.C. § 2900(f) to "subdivision (d)" is a legislative typo; the reference should be to "subdivision (e).")

(f) [6:655] **Issuance of order:** If the moving party meets the burden of proof as to any of the proffered grounds for security (¶ 6:650 ff.), the court must order that the plaintiff-shareholder post a bond as security for the moving-defendant's litigation expenses.

1) [6:655.1] **Amount of bond:** The court fixes the amount of the bond, which may not exceed $50,000. This $50,000 maximum applies in the *aggregate* as to *all* moving defendants, not to each moving party separately. [Corps.C. § 800(d); see also Corps.C. § 2900(e) (SPCs); *Hale v. Southern Calif. IPA Med. Group, Inc.* (2001) 86 CA4th 919, 927-928, 103 CR2d 773, 778]

The court has discretion to increase or decrease the bond, within the $50,000 ceiling, upon a showing that it has become inadequate or excessive.

2) [6:656] **Not a decision on the merits:** The court's order granting or denying the motion is not a determination of any issue in the action or the merits thereof. [Corps.C. § 800(d); see also Corps.C. § 2900(e) (SPCs)]

Moreover, the order is not appealable. [*Woodman v. Ackerman* (1967) 249 CA2d 644, 652, 57 CR 687, 692; *Efron v. Kalmanovitz* (1960) 185 CA2d 149, 152, 8 CR 107, 109]

(g) [6:657] **Suit dismissed if plaintiff fails to post security:** If the plaintiff-shareholder fails to post the required bond as to any defendant within the time set by the court, the action must be *dismissed* as to that defendant. [Corps.C. § 800(d); see also Corps.C. § 2900(e) (SPCs)] But plaintiff is entitled to appeal from such a dismissal. [*Woodman v. Ackerman* (1967) 249 CA2d 644, 652, 57 CR 687, 692]

1) [6:657.1] **Defendant not entitled to attorney fees:** The moving party-defendant is *not* entitled to an award of attorney fees as Corps.C. § 800(c) litigation expenses (¶ *6:643*) where the suit is dismissed because plaintiff fails to post the required bond. [*Freeman v. Goldberg* (1961) 55 C2d 622, 626, 12 CR 668, 670]

(4) [6:658] **Plaintiff may avoid dismissal by posting bond:** Plaintiff may voluntarily furnish a $50,000 bond to secure the expenses of those defendants entitled to seek such security (¶ 6:644). If this is done, any pending motions for security must be dismissed and no further motions may be filed. [Corps.C. § 800(e); see Corps.C. § 2900(g) (SPCs); and *Donner Mgmt. Co. v. Schaffer* (2006) 142 CA4th 1296, 1304, 48 CR3d 534, 538]

(Note re SPCs: The reference in Corps.C. § 2900(g) to "subdivision (d)" is a legislative typo; the reference should be to "subdivision (e).")

(a) [6:658.1] **Prevailing defendant relieved of showing "no reasonable possibility" of benefit to corporation:** When plaintiff voluntarily posts a $50,000 bond, a prevailing defendant may seek recourse against the security (¶ *6:659*) without having to retrospectively show that the suit had "no reasonable possibility" of benefiting the corporation (¶ *6:650*). [*Donner Mgmt. Co. v. Schaffer* (2006) 142 CA4th 1296, 1305, 48 CR3d 534, 539]

1) [6:658.2] **Effect:** Such a severe result arguably may discourage plaintiffs from voluntarily posting bond. However, by eliminating litigation of the bond motion, plaintiff enjoys a speedier resolution of the lawsuit. [*Donner Mgmt. Co. v. Schaffer* (2006) 142 CA4th 1296, 1307, 48 CR3d 534, 540]

➪ [6:658.3] ***PRACTICE POINTER:*** Plaintiff and defendant may stipulate that plaintiff will voluntarily post bond on the condition that, if defendant prevails, defendant can recover on the bond only upon demonstrating that the lawsuit showed no reasonable possibility of benefit to the corporation at the time it was filed.

[6:658.4 - 6:658.5] ***Reserved.***

(b) [6:658.6] **Compare—other statutory requirements not supplanted by bond:** Read literally, Corps.C. § 800(e) seems to suggest plaintiff's posting such a bond will satisfy *all* of the § 800 requirements for bringing a derivative suit,

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

including contemporaneous share ownership (Corps.C. § 800(b)(1), ¶ *6:614 ff.*) and demand upon the board of directors (Corps.C. § 800(b)(2), ¶ *6:622 ff.*). But such a reading would produce anomalous consequences; the mere posting of a bond as security for expenses hardly serves as a substitute for the protections provided by these other requirements. [*Shields v. Singleton* (1993) 15 CA4th 1611, 1618-1620, 19 CR2d 459, 463-465—posting bond does not eliminate requirement of demand upon directors]

(5) [6:659] **Prevailing defendants entitled to claim security:** Any defendant who prevails in the derivative suit (¶ 6:659.1), and for whom plaintiff was required to post security, is entitled to recourse to the security for "reasonable expenses, including attorneys' fees" incurred in the action. The precise amount of such claims must be fixed by the court. (It is unclear what factors the court must consider in making this determination.)

Moreover, if there is no recovery by the corporation because the plaintiff lost the derivative suit, the corporation may recover its litigation expenses from the security. Such expenses may include corporate payments under Corps.C. § 317 to indemnify officers and/or directors named in the action (¶ *6:439*). [Corps.C. § 800(d); also see *Donner Mgmt. Co. v. Schaffer* (2006) 142 CA4th 1296, 1309, 48 CR3d 534, 541 (citing text); *Brusso v. Running Springs Country Club, Inc.* (1991) 228 CA3d 92, 103, 278 CR 758, 763 (citing text); and Corps.C. § 2900(e) (SPCs)]

(a) [6:659.1] **"Prevailing party" determination:** The prevailing party is determined by the trial court based on an evaluation of whether the party prevailed "on a practical level." [*Donner Mgmt. Co. v. Schaffer* (2006) 142 CA4th 1296, 1309-1310, 48 CR3d 534, 541-543]

• [6:659.2] Defendant prevails where plaintiff *voluntarily dismisses* a derivative action following a determination by the corporation's special litigation committee that continuance of the litigation is not in the corporation's best interests (*see* ¶ *6:634 ff.*). This is so even if the dismissal is "without prejudice." In these circumstances, dismissal is not truly voluntary but, rather, is compelled by the litigation committee's decision, which precludes prosecution of the lawsuit. [*Donner Mgmt. Co. v. Schaffer* (2006) 142 CA4th 1296, 1311, 48 CR3d 534, 543]

[6:659.3 - 6:659.5] ***Reserved.***

(b) [6:659.6] **Recovery of litigation expenses limited to security:** Recovery of the prevailing defendants' litigation expenses is limited to the posted security. Corps.C. § 800 is not a general "fee-shifting" statute and hence does not authorize defendants to recover from plaintiff any amount that exceeds the bond. And where *no* security is posted, the prevailing defendants are not entitled to recover their attorney fees incurred in successfully defending the derivative suit (unless another statute or a contract expressly allows recovery of attorney fees). [*Freeman v. Goldberg* (1961) 55 C2d 622, 625-626, 12 CR 668, 670; *West Hills Farms, Inc. v. RCO AG Credit, Inc.* (2009) 170 CA4th 710, 717-719, 88 CR3d 458, 462-464 & fn. 11; *Donner Mgmt. Co. v. Schaffer* (2006) 142 CA4th 1296, 1304, 48 CR3d 534, 537 (citing text); see *Brusso v. Running Springs Country Club, Inc.* (1991) 228 CA3d 92, 106-108, 278 CR 758, 765-766—notwithstanding plaintiffs' failure to post security, defendants may recover expenses if underlying dispute is over contract containing prevailing party attorney fee recovery clause (Civ.C. § 1717)]

(c) [6:660] **Compare—liability for court costs:** Like any other litigant, a plaintiff-shareholder who loses a derivative suit is also liable for *court costs* incurred by the prevailing parties. [CCP § 1032(b)]

(6) Application to derivative suits in federal court

(a) [6:661] **Diversity cases:** State security-for-expenses statutes, such as Corps.C. § 800, apply to diversity of citizenship derivative suits brought in federal court. [*Cohen v. Beneficial Industrial Loan Corp.* (1949) 337 US 541, 555-556, 69 S.Ct. 1221, 1230]

(b) [6:662] **Securities law cases:** On the other hand, such security-for-expenses statutes do *not* apply where the derivative suit is based on federal securities law violations (e.g., SA 1933 and SEA 1934, including SEC Rule 10b-5). [*J.I. Case Co. v. Borak* (1964) 377 US 426, 434-435, 84 S.Ct. 1555, 1561 (abrogation on other grounds recognized by *Ziglar v. Abbasi* (2017) 582 US 120, 131-132, 137 S.Ct. 1843, 1855); *Weitzen v. Kearns* (SD NY 1966) 262 F.Supp. 931, 932, aff'd 388 F2d 310, 311 (per curiam)]

(c) [6:663] **Supplemental claims:** But the security-for-expenses statutes *do* apply to state law derivative actions that are joined with federal claims in federal court suits under the doctrine of supplemental jurisdiction. [*J.I. Case Co. v. Borak*

(1964) 377 US 426, 434-435, 84 S.Ct. 1555, 1561 (abrogation on other grounds recognized by *Ziglar v. Abbasi* (2017) 582 US 120, 131-132, 137 S.Ct. 1843, 1855); *Phelps v. Burnham* (2nd Cir. 1964) 327 F2d 812, 814]

f. [6:664] **Defenses to derivative suits:** As stated above (¶ 6:355), a derivative suit cause of action belongs to the corporation, and the shareholders merely "stand in the corporation's shoes." Thus, any defense that could have been raised in an action brought by the corporation itself can also be asserted in a derivative suit (e.g., statute of limitations, res judicata, agreement to arbitrate, etc.). [See *Gagnon Co., Inc. v. Nevada Desert Inn, Inc.* (1955) 45 C2d 448, 453, 289 P2d 466, 471—res judicata barred derivative suit where corporation lost its own action based on same wrong; *Frederick v. First Union Secur., Inc.* (2002) 100 CA4th 694, 697, 122 CR2d 774, 776—corporation's arbitration agreement with broker binding in shareholder's derivative action alleging broker conspired with officers to inflate stock price]

(1) [6:665] **Exception—corporate incapacity to sue caused by defendants:** However, a derivative suit has been allowed on behalf of a corporation *suspended for nonpayment of franchise taxes*, and thus incapacitated from prosecuting a cause of action against allegedly dishonest officers and directors (*¶ 6:564*). Reason: The shareholders are not able to compute and file the required tax return, thus it would be "inequitable" to allow allegedly dishonest management to hide behind a shield of corporate incapacity which they themselves created. [*Reed v. Norman* (1957) 48 C2d 338, 343, 309 P2d 809, 812; compare *Moore v. Hill* (2010) 188 CA4th 1267, 1271, 116 CR3d 140, 143, fn. 3—payment of taxes not excused in derivative suit against investors where plaintiff shareholder controlled corporations and had power to revive them; but see *Smith v. Lewis* (1930) 211 C 294, 298, 295 P 37, 39 (contra)]

(2) [6:666] **Equitable defenses:** Since a derivative suit is a proceeding in equity, "equitable defenses" such as laches, unclean hands and in pari delicto may be asserted to bar plaintiff's action. Thus, for example, shareholders who participate or acquiesce in the wrong complained of are barred by their own "unclean hands" from maintaining a derivative suit. [*Rosenfeld v. Zimmer* (1953) 116 CA2d 719, 722-723, 254 P2d 137, 139-140—shareholder barred from bringing derivative suit against contractor to recover amounts paid by corporation under a sham contract made with shareholder's knowledge and consent]

(3) [6:666.1] **Waiver and res judicata:** As a corollary to the rule that the right of action belongs to the corporation, a derivative claim can be forfeited, waived or adjudicated by the corporation's actions. It does not matter that the individual plaintiffs bringing the derivative suit were not parties to the prior action giving rise to a waiver or res judicata defense. The plaintiffs "stand in the shoes" of the corporation and are subject the procedural rules that would apply to the *corporation* as plaintiff in a direct action. [*Heshejin v. Rostami* (2020) 54 CA5th 984, 994-996, 268 CR3d 836, 844-846—compulsory cross-complaint rule barred plaintiffs' derivative claims because company previously failed to assert claims in prior action, even though plaintiffs were not parties to prior action; *Scarborough v. Briggs* (1947) 81 CA2d 161, 166, 183 P2d 683, 686—res judicata barred plaintiffs from bringing derivative claims on behalf of corporate entity, even though plaintiffs were not parties in prior action]

g. [6:667] **Settlement and recovery:** As discussed above, any settlement or recovery belongs to the corporation, except in unusual situations (*¶ 6:605*). The plaintiff-shareholder has no power to settle or compromise the action without court approval. [*Whitten v. Dabney* (1915) 171 C 621, 630-631, 154 P 312, 316; *Ensher v. Ensher, Alexander & Barsoom, Inc.* (1960) 187 CA2d 407, 410, 9 CR 732, 734]

The trial court may impose whatever conditions it deems equitable before approving a settlement. This could include requiring notice to other shareholders, and a hearing on the proposed settlement (as required under FRCP 23.1). [See, e.g., *Silber v. Mabon* (9th Cir. 1992) 957 F2d 697, 701-702—notice of proposed settlement must be "best practicable" to reach beneficial owners of shares held in "street" name (NOBOs, *see ¶ 6:538.1 ff.*); *In re Pacific Enterprises Secur. Litig.* (9th Cir. 1995) 47 F3d 373, 377—in FRCP 23.1 derivative action, judge must give reasons for overruling settlement objections]

(1) [6:667.1] **Shareholder standing to object to settlement:** In derivative suits governed by *federal* law (e.g., SEC Rule 10b-5), a shareholder seeking to object to a proposed settlement can be required to possess the same qualifications necessary to act as a representative plaintiff in the action (per FRCP 23.1, *see ¶ 6:620a ff.*). Thus, a shareholder who has a conflict of interest with the other shareholders (e.g., is pursuing individual litigation against the corporation) typically *lacks* standing to object. [See, e.g., *Zarowitz v. BankAmerica Corp.* (9th Cir. 1989) 866 F2d 1164, 1166; *Darrow v. Southdown, Inc.* (5th Cir. 1978) 574 F2d 1333, 1336-1337]

(2) [6:667.2] **Settlement as bar to subsequent suit (claim preclusion):** Under the general doctrine of claim preclusion (res judicata), a final judgment on the merits bars a subsequent action between the same parties over the same cause of action.

When two persons are so closely aligned in interest that one is the *virtual representative* of the other, a claim by or against one will serve to bar the same claim by or against the other. [*In re Imperial Corp. of America* (9th Cir. 1996) 92 F3d 1503, 1506]

• [6:667.3] **Application:** Thus, a court-approved settlement of a derivative action alleging mismanagement on the part of a corporation's officers and directors barred the receiver for the corporation's wholly-owned subsidiary from bringing a subsequent action against the officers and directors for mismanagement of the subsidiary. The officers and directors of the parent and subsidiary were the same, and the two suits were based on the same acts of mismanagement, all of which involved the subsidiary. [*In re Imperial Corp. of America* (9th Cir. 1996) 92 F3d 1503, 1507-1509]

[6:667.4 - 6:667.9] ***Reserved.***

(3) [6:667.10] **Settlement no bar to malpractice claim against counsel:** Court approval of a settlement—even when accompanied by an express finding of fairness, adequacy and reasonableness—does not preclude a subsequent malpractice action against the attorneys who represented the corporation in the derivative action. The "fairness" finding was necessarily based upon the case as presented to the court, and the issue is whether the attorneys were negligent in making that presentation. [*Durkin v. Shea & Gould* (9th Cir. 1996) 92 F3d 1510, 1515-1517]

h. [6:668] **Payment of plaintiff's expenses:** If the corporation obtains a monetary recovery from a successful derivative suit, the plaintiff shareholder is entitled to reimbursement for reasonable legal fees and litigation costs incurred in prosecuting the action. Such reimbursement is awarded out of the recovery under the equitable "common fund doctrine"; i.e., one who brings an action to create or preserve a "common fund" for the benefit of others (e.g., the corporation and its other shareholders) is entitled to be made whole for their reasonable and necessary expenses. [*Cziraki v. Thunder Cats, Inc.* (2003) 111 CA4th 552, 557-558, 3 CR3d 419, 422-423; see *Baker v. Pratt* (1986) 176 CA3d 370, 378, 222 CR 253, 257-258]

[6:669] Even in the absence of a monetary recovery, plaintiff may be entitled to fees and costs reimbursement where the derivative suit conferred a "substantial benefit" upon the corporation (e.g., by *preventing* an abuse prejudicial to the interests of the corporation or its shareholders). But such benefit must extend to a "clearly identifiable class of persons." [*Baker v. Pratt*, supra; *Fletcher v. A.J. Indus., Inc.* (1968) 226 CA2d 313, 320-323, 72 CR 146, 150-151; see *Brusso v. Running Springs Country Club, Inc.* (1991) 228 CA3d 92, 111, 278 CR 758, 769; but see *Beehan v. Lido Isle Comm. Ass'n* (1977) 70 CA3d 858, 866, 137 CR 528, 532]

(1) [6:670] **Application in derivative action against other shareholders in closely-held corporation:** Where a shareholder in a closely-held corporation (e.g., two or three shareholders) obtains a monetary recovery in a derivative action against the other shareholders, the "common fund doctrine" arguably should not apply because, as a practical matter, only the plaintiff shareholder benefits from the recovery. However, the number of shareholders who benefit from the recovery is not determinative; rather, the focus is on whether the judgment benefits the *corporation*. A plaintiff whose only benefit comes *indirectly as a shareholder* is still entitled to reimbursement of their litigation expenses. [*Cziraki v. Thunder Cats, Inc.* (2003) 111 CA4th 552, 559-565, 3 CR3d 419, 424-429]

(a) [6:670.1] **Distinguish—plaintiff shareholder receiving *personal benefit:*** The result is otherwise where the benefit inures entirely to plaintiff *directly* … as where a 50% shareholder in a derivative action against the other 50% shareholder (i) obtains recovery *solely on one or more other claims that are not derivative* (i.e., plaintiff recovers directly against defendants) or (ii) the derivative recovery inures entirely to plaintiff because the corporation is being *dissolved*. In such circumstances, there is no "common fund" from which plaintiff can obtain their litigation expenses. [*Baker v. Pratt* (1986) 176 CA3d 370, 378, 222 CR 253, 257-258; compare *Cziraki v. Thunder Cats, Inc.* (2003) 111 CA4th 552, 560-561, 3 CR3d 419, 425—plaintiff shareholder who pursued his "personal adverse interests" in separate individual claims could obtain cost reimbursement from derivative recovery]

[6:670.2 - 6:670.4] ***Reserved.***

(2) [6:670.5] **Effect of involuntary sale of plaintiff's stock during derivative action:** *See ¶ 6:618.3*.

(3) [6:670.6] **Court approval of attorney fees negotiated as part of settlement:** Where settlement of a derivative action includes a negotiated amount for plaintiff's attorney fees, the court must review the fees to determine that, together with the rest of the settlement, they are *fair*, *honestly negotiated* and *free from fraud or collusion*. [*Robbins v. Alibrandi* (2005) 127 CA4th 438, 444, 26 CR3d 387, 390]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

This is so whether the fees are paid by the corporation, the directors or an insurer. In most cases, an agreement to pay fees will have a direct pecuniary impact on the shareholders and/or the corporation, because the negotiated fees might reduce the amount of damages recovered by the shareholders, be paid out of corporate assets, or, where covered by insurance, result in increased premiums or difficulty in obtaining insurance. Thus, plaintiff's attorneys owe an ethical and fiduciary duty to limit fees to an amount bearing a *reasonable relationship to the value of their work*, and fees exceeding a fair and reasonable amount may not be approved. [*Robbins v. Alibrandi*, supra, 127 CA4th at 444, 449-452, 26 CR3d at 390, 395-397]

i. [6:671] **Indemnification of directors and officers:** The corporation may indemnify its officers and directors for expenses they incur in defending suits against them for activities undertaken in their corporate capacity. This applies not only to derivative suits, but also to direct actions brought by the corporation, its shareholders or third parties. The extent to which indemnification may be provided depends on whether the corporation has adopted an articles provision permitting indemnification greater than that permitted by Corps.C. § 317 (*see ¶ 6:436 ff.*).

(1) [6:672] **Insurance against derivative liability:** Moreover, the corporation may purchase liability insurance protecting its officers and directors against some kinds of derivative liability; *see ¶ 6:466 ff.*

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki ‘Vicki’ Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:A] Reminder Letter for Annual Shareholders' Meeting

[NAME & ADDRESS
OF OFFICER OF
CORPORATION]
Re: Annual Meeting of Shareholders
Dear *Mr./Ms./Mrs.*____________*:*

The bylaws of the ________________ Corporation require that the annual meeting of shareholders should be scheduled each year on the first Monday in May, which this year is May _, _. Notice to the Shareholders must be given _ days in advance of the meeting.

A suggested agenda for the annual meeting includes:

(1) Election of directors;

(2) Annual report to the shareholders;

(3) Other specified matters requiring shareholder approval; and

(4) Any other proper business.

Following the shareholders' meeting, a meeting of the new board of directors should be held; and the new board of directors should elect officers to serve during the coming year, and take up any other matters requiring their attention.

Please call me so that we can arrange a conference to prepare for the meeting and discuss other matters that should be included on the agenda.

Very truly yours,
/s/

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:B] Call for Special Meeting of Shareholders

TO: Secretary, ________________ Corporation

The undersigned, the holder(s) of shares entitled to cast not less than 10 percent of the votes of the ________________ Corporation, do hereby call a special meeting of the shareholders of said corporation to be held ___________ *(date)*, at ___________ *(time)*, for the purpose of considering and acting upon the following matters: ________ *(Insert matters to be considered.)*..

You are directed to give notice of said meeting, in the manner prescribed by the Bylaws of said corporation and applicable law, to all shareholders entitled to receive notice of, and to vote at, the meeting.

DATED: ___________	
	/s/
	/s/
	/s/

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:C] Notice of Annual Meeting of Shareholders

NOTICE OF ANNUAL MEETING

OF SHAREHOLDERS OF

_____ CORPORATION

Notice is hereby given that an annual meeting of the shareholders of ________________ Corporation will be held at _____ *(time)*, on ___________ *(date)*, at ________________ *(address)*. The meeting will consider and act on the following:

(1) Election of directors.

(2) Annual report to shareholders.

(3) ________________ *(General nature of other business to be considered)*.

(4) Other business as may properly be brought before the meeting.

(If applicable, specify the means of electronic transmission, electronic video screen communication, conference telephone, or other means of remote communication by which shareholders may participate in the meeting.)

If you do not expect to be present at the meeting and wish your shares to be voted, you may complete the attached form of proxy and mail it in the enclosed addressed envelope.

DATED: _____ /s/ ________________
(Secretary or other officer of corporation)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:D] Notice of Special Meeting of Shareholders

NOTICE OF SPECIAL MEETING

OF SHAREHOLDERS OF

_____ CORPORATION

Pursuant to a call made by the Board of Directors, notice is hereby given that a special meeting of the shareholders of ________________ Corporation will be held at _____ *(time)*, on ___________ *(date)*, at ________________ *(address)*, to consider and act on the following:

(1) ________________ *(general nature of business to be considered).*

(2) Other business as may properly be brought before the meeting.

(If applicable, specify the means of electronic transmission, electronic video screen communication, conference telephone, or other means of remote communication by which shareholders may participate in the meeting.)

If you do not expect to be present at the meeting and wish your shares to be voted, you may complete the attached form of proxy and mail it in the enclosed addressed envelope.

DATED: _____ /s/ ________________
(Secretary or other officer of corporation)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:E] Waiver of Notice and Consent to Holding of (Annual/Special) Meeting of Shareholders

WAIVER OF NOTICE AND CONSENT TO

HOLDING OF (ANNUAL/SPECIAL) MEETING

OF SHAREHOLDERS OF

___________ CORPORATION

The undersigned shareholder(s) of ________________ Corporation, a California Corporation, desiring to hold an *(annual/special)* meeting at _____ *(time)*, on ___________ *(date)*, at ___________ ___________ *(address)*, hereby waive notice of, and consent to the holding of, such meeting.

The undersigned agree that any business transacted at that meeting shall be as valid and legal as though that meeting were held after notice was duly given.

DATED: ___________	*/s/*
	/s/
	/s/
	/s/

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:F

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:F] PROXY

(For Use With Corporations having Fewer Than 100 Shareholders)

PROXY

The undersigned, as record owner of the shares of ___________ Corporation described below, hereby appoints ________________ as the proxy of the undersigned to attend the meeting of the shareholders of said corporation on ________________ *(date)*, and any adjournment, postponement or continuation thereof, and to represent, vote, execute, consent, waive and otherwise act for the undersigned in the same manner and with the same effect as if the undersigned were personally present at said meeting.

This proxy may be revoked at any time by the undersigned and unless revoked earlier shall terminate on ___________, *(date)*.

Number and Class of Shares Owned: ________________

DATED: ___________

....
Signature

....
Name (typed or printed)

....
Address

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:G

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:G] PROXY

(For Use With Corporations having 100 or More Shareholders)

PROXY

The undersigned, as record owner of the shares of ___________ Corporation described below, hereby appoints ________________, as the proxy of the undersigned, to attend and vote at the *(annual/special)* meeting of the shareholders of ________________ Corporation, to be held at ________________, on ________________, at ________________, and any adjournment, postponement or continuation thereof, and to represent, vote, execute, consent, waive and otherwise act for the undersigned in the same manner and with the same effect as if the undersigned were personally present at said meeting.

The shares represented by this proxy shall be voted in the following manner:

ACTIONS PROPOSED TO BE TAKEN	FOR	AGAINST	ABSTAIN
Proposal No. 1 (Describe Proposal)	[ ]	[ ]	[ ]
Proposal No. 2 (Describe Proposal)	[ ]	[ ]	[ ]
FOR ELECTION AS DIRECTOR(S)	**FOR**	**AGAINST**	**WITHHOLD**
___________ *(Name)*	[ ]	[ ]	[ ]
___________ *(Name)*	[ ]	[ ]	[ ]
___________ *(Name)*	[ ]	[ ]	[ ]

IF NO INDICATION IS MADE ON HOW YOU DESIRE YOUR SHARES TO BE VOTED, THE PROXY HOLDER WILL HAVE COMPLETE DISCRETION IN VOTING THE SHARES ON ANY MATTER VOTED ON AT THE MEETING.

Number and Class of Shares Owned: ___________

DATED: ___________ ___________

Signature(s)

____
Name(s) (typed or printed)

____
Address(es)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:H

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:H] Minutes of (Annual/Special) Shareholders' Meeting

MINUTES OF (ANNUAL/SPECIAL) MEETING

OF SHAREHOLDERS OF

___________ CORPORATION

A *(special/annual)* meeting of the shareholders of ___________ Corporation, a California corporation, was held on ___________ *(date)*, at ________________.

The following shareholders were present at the meeting, in person or by proxy, representing shares as indicated:

____
________________ *(Names and No. of shares)*
____

The following persons also were present:

________________ *(Names)*
____
____

The *(president, chairperson of the board or other)* of the corporation called the meeting to order and announced that *(he or she)* would chair the meeting, and that a quorum was present and that the meeting was held pursuant to a written notice of meeting given to all shareholders of the corporation. A copy of this notice was ordered inserted in the minute book immediately preceding the minutes of this meeting.

The minutes of the previous meeting of shareholders were then read and approved.

The chairperson then announced that the election of directors was in order. The chairperson explained the right of shareholders to cumulate their votes, and that cumulative voting for directors would obtain if any shareholder now stated their intent to cumulate votes. *[Shareholder ___________ being present (or represented by proxy) then announced an intention to cumulate votes]* or *[No such intention being declared, the chairperson announced that the directors would be elected by straight voting.]*

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

The following persons were nominated: *(List persons nominated)*. Directors were then elected to serve until the next annual meeting of stockholders, and until their successors were duly elected and qualified, as follows:

(List persons elected)

(Insert other business conducted at meeting)

There being no further business to come before the meeting, on motion duly made, seconded, and adopted, the meeting was adjourned.

	/s/
	Secretary

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:I

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:I] Action by Written Consent of Shareholders

(Corps.C. § 603)

WRITTEN CONSENT OF
SHAREHOLDER(S) OF

_____ CORPORATION

The undersigned shareholder(s) of ___________ Corporation, a California corporation, owning of record the number of shares entitled to vote as set forth, hereby consent(s) to the following actions of the corporation:

(Set forth resolution to be adopted)

DATED: ___________

____
(Signature(s) of Shareholder(s))

____
(Typed name(s))

____
(Number of shares)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:J

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:J] Resolution Appointing Directors' Committee

RESOLUTION APPOINTING DIRECTORS' COMMITTEE

WHEREAS, Section 311 of the California General Corporation Law and the Bylaws of the Corporation authorize the Board of Directors to designate one or more Directors' Committees of the Corporation;

WHEREAS, it is deemed to be in the best interests of this corporation and of its shareholders that a Directors' Committee on ____________ be appointed;

NOW, THEREFORE, BE IT RESOLVED, that a Directors' Committee on ____________ is hereby appointed, and the following directors are hereby appointed as members of such Committee: ____________

RESOLVED FURTHER, that each member of said Directors' Committee shall serve as such until such member's successor shall be appointed by the Board. In the event any member of such Committee shall resign or cease to be a director of this corporation, the vacancy thus caused shall be filled by the Board; and

RESOLVED FURTHER, that the members of the Directors' Committee shall adopt rules of procedure for the conduct of the meetings and decide where such meetings shall take place and, in the absence of the adoption of any such rules, the meetings and procedures of the Committee shall be conducted in accordance with the rules and procedures set forth in the Corporation's Bylaws for the conduct of meetings of the Board of Directors of the Corporation.

RESOLVED FURTHER, that the Directors' Committee shall have and may exercise all the powers and authority of the Board in the management of the business and affairs of this corporation *(with respect to ____________)*.

(Insert any limitations or controls required by Section 311 of the Corporations Code*)*

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:K

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:K] Notice of Special Board Meeting

NOTICE OF SPECIAL MEETING OF THE BOARD
OF DIRECTORS OF

_____ CORPORATION

Notice is hereby given that a special meeting of the board of directors of ___________ Corporation has been called by the president of the corporation to be held at _____ *(time)*, on ___________ *(date)*, at ___________ *(address)* to consider and act on the following matters and such other business as may properly come before the board.

(Set forth business to be considered)

DATED: ___________

/s/
Secretary for Corporation

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:L

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:L] Waiver of Notice of Board Meeting

WAIVER OF NOTICE AND CONSENT TO HOLDING OF SPECIAL
MEETING OF BOARD OF DIRECTORS OF

___________ CORPORATION

The undersigned, members of the board of directors of _____ Corporation, a California corporation, hereby waive notice of and consent to the holding of a special meeting of the board of directors at _____ *(time)*, on _____ *(date)*, at ___________ *(address)*, and agree that any business transacted at that meeting shall be as valid and have the same force and effect as though that meeting were held after notice duly given.

DATED: ___________ *<u>/s/</u>*
<u>/s/</u>
<u>/s/</u>

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:M

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:M] Minutes of Directors' (Annual/Special) Meeting

MINUTES OF (ANNUAL/SPECIAL) MEETING OF BOARD
OF DIRECTORS OF

_____ CORPORATION

A(n) *(annual/special)* meeting of the board of directors of ___________ Corporation, a California corporation, was held at _____ *(time)*, on ___________ *(date)*, at ___________ _____ *(address)*.

The following directors were present at the meeting:

(List names)

The following persons also were present at the meeting:

(List names)

The chairperson called the meeting to order and announced that the meeting was held pursuant to written waiver of notice and consent to the holding of the meeting. The waiver and consent was presented to the meeting and, on a motion duly made, seconded, and carried, was made a part of the records and ordered inserted in the minutes book immediately preceding the records of this meeting.

It was then moved, seconded, and resolved to dispense with the reading of the minutes of the last meeting.

The chairperson stated that the election of new officers was in order. The board then proceeded to elect new officers of the corporation. Upon motion duly made, seconded and carried, the following persons were duly elected to the corporate offices next to their name as set forth below:

Name	Office
....	....
....	....

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(Insert Other Business Considered)

There being no further business to come before the meeting, the meeting was duly adjourned.

/s/

____

Secretary

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:N

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:N] Directors' Action by Unanimous Written Consent

DIRECTORS' ACTION BY UNANIMOUS
WRITTEN CONSENT

Pursuant to California Corporations Code Section 307(b), the undersigned directors of ___________ Corporation, a California corporation, hereby consent to the following action without a meeting:

(Insert resolutions adopted)

DATED: ___________ /s/
/s/
/s/

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:O

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:O] Assignment of Shares Separate From Certificate

ASSIGNMENT OF SHARES SEPARATE FROM CERTIFICATE

FOR VALUE RECEIVED, I ________________, hereby sell, assign, and transfer _____ shares of stock of ___________ Corporation, standing in the undersigned name on the books of said corporation, represented by Certificate No. _____ to ___________.

DATED: ___________	*/s/*
	(Signature)
	....
	(Print or Type Name)
	....
	(Address)
....	
WITNESS	

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 6:P

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki ‘Vicki’ Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 6. Operating Problems

Forms

[Form 6:P] Transmittal Letter to Transferee Accompanying New Certificate

Dear ___________:

Enclosed is Certificate No. ___, representing _____ shares of common stock of _____ Corporation. The shares represented by the enclosed Certificate are subject to a transfer restriction imposed as a condition of a permit issued by the California Commissioner of Financial Protection and Innovation. Please note that the Certificate bears the following legend restriction:

> “It is unlawful to consummate a sale or transfer of this security, or any interest therein, or to receive any consideration therefor, without the prior written consent of the Commissioner of Financial Protection and Innovation [formerly the Commissioner of Business Oversight] of the State of California, except as permitted in the Commissioner's rules.”

As required by Financial Protection and Innovation Commissioner Rules, we are also enclosing a copy of Section 260.141.11 of Title 10 of the California Code of Regulations, which sets forth the restrictions and regulations governing the transfer of the enclosed Certificate.

	/s/
	Secretary

Encl.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. ¶ 7:1

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 7. Dividends and Other Distributions

[7:1] Overview

This Chapter focuses on "getting the money out of the corporation." It covers an operating corporation's dividends and other distributions to its shareholders as profits on shareholder investments or to repurchase their shares.

Of course, these types of payments must be distinguished from amounts paid to shareholders in exchange for their services or property—e.g., as salaries, loan repayments, rent, etc. (But even payments for services or property may, under certain circumstances, be treated as "constructive" dividends to shareholders; *see ¶ 2:106*.) Also distinguishable are payments in liquidation of the corporation following its dissolution (*see ¶ 8:944*).

As will be seen, dividends and other distributions to shareholders are subject to special regulation under the Corporations Code, in order to protect those with senior claims to the corporate assets—i.e., creditors and preferred stockholders.

Shareholder distributions are given special treatment for tax purposes, and the tax definitions differ in important respects from the corporate terminology (*see ¶ 7:177 ff.*).

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 7-A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 7. Dividends and Other Distributions

A. Distributions Subject to Regulation

1. [7:2] "Distribution to Shareholders" Defined
a. [7:3] Code exclusions
(1) [7:3.1] Stock dividends
(a) [7:3.2] Rationale
(2) [7:3.3] Rescission of share issuances
(a) [7:3.4] Only disinterested directors may vote
(3) [7:3.5] Repurchase under employee stock option plans
b. [7:4] Compare—stock splits
2. [7:5] Substance vs. Form of Distribution
a. [7:6] Formal declaration not essential
(1) [7:7] Example
b. [7:8] Disguised ("constructive") dividends
(1) [7:9] Compare—unequal distributions

1. [7:2] **"Distribution to Shareholders" Defined:** The following kinds of corporate payments to shareholders are subject to regulation under the Corporations Code as "distributions to shareholders":

• *Transfers* of cash or property, by way of dividend or otherwise, *without consideration* (excluding stock dividends, ¶ 7:3.1); or

• *Redemptions* of the corporation's own shares (for cash or property); or

• *Purchases* of its own shares (for cash or property); or

• Any such transfer, redemption or purchase effected through a *subsidiary* of the corporation. [Corps.C. § 166]

a. [7:3] **Code exclusions:** The Code expressly excludes certain payments from the regulations for shareholder "distributions" (Corps.C. § 166):

(1) [7:3.1] **Stock dividends:** Distribution of additional shares of the corporation's own stock as a dividend on shares outstanding is expressly excluded from "distributions to shareholders" subject to regulation (¶ 7:10 ff.). [See Corps.C. § 166]

(a) [7:3.2] **Rationale:** The reason, of course, is that a stock dividend is not a transfer of the corporation's "cash" or "property," and thus has no effect on the amount of assets available to creditors and preferred shareholders. Rather, distribution of additional shares merely divides the corporation's ownership into a larger number of outstanding shares. (*See discussion at ¶ 7:245.*)

(2) [7:3.3] **Rescission of share issuances:** Also, payment (or return of consideration received by the corporation upon issuing shares) *in rescission* of a share issuance (e.g., due to securities law violations; *see ¶ 5:359 ff.*) is not a "distribution to

shareholders" … *provided* the rescission is made pursuant to a final court order, or ordered by the board upon determining that:

• The affected shareholders could obtain a court order for rescission; and

• Rescission is in the corporation's best interests; and

• The corporation will still likely be able to meet its debts as they mature. [Corps.C. § 166]

(a) [7:3.4] **Only disinterested directors may vote:** Such a board determination must be taken by the *disinterested* directors—i.e., any director who is, or would be, a party to the rescission is not entitled to vote. [Corps.C. § 166]

(3) [7:3.5] **Repurchase under employee stock option plans:** Repurchases by the corporation of employees' shares issued pursuant to employee stock option plans (or agreements) established under Corps.C. § 408 are also excluded (*see* ¶ *7:132*). Again, however, there must be a disinterested board determination that the repurchase is in the corporation's best interests and is not likely to render it unable to meet its liabilities. [Corps.C. § 166]

b. [7:4] **Compare—stock splits:** Likewise, while not expressly excluded by Corps.C. § 166, a corporation's issuance of additional shares as a stock split (or for any other purpose) is not a "distribution to shareholders," and hence not subject to regulation. Rationale: As with the stock dividend exclusion, the corporation's issuance of additional shares does not change the amount of corporate assets available to the creditors or preferred stockholders. (*See discussion at* ¶ *7:255*.)

2. [7:5] **Substance vs. Form of Distribution:** Any corporate payment to shareholders which has the *effect* of a *division of profits* is subject to regulation as a "distribution to shareholders."

In other words, every corporate "disbursement that is not an expenditure for the corporation's benefit—that is not a purchase, a loan …, the repayment of a debt, an ordinary and necessary business expense, etc.—must be a dividend, for if it does not benefit the corporation it must benefit the shareholders." [*United States v. Mews* (7th Cir. 1991) 923 F2d 67, 68-69]

This covers ordinary dividends, as well as payments by a corporation to repurchase or redeem its own shares. It also covers payments which are "constructive" or "disguised" dividends (¶ 7:8).

Such payments are subject to regulation because they have the same effect as far as creditors and preferred stockholders are concerned: i.e., they reduce the corporate assets available to satisfy their prior claims.

a. [7:6] **Formal declaration not essential:** It follows that a "distribution to shareholders" does not depend on formal action or authorization by the board of directors. Any division of profits among the shareholders, whether in the form of a dividend or otherwise, is subject to regulation as a "distribution to shareholders." [Corps.C. § 166]

(1) [7:7] **Example:** Director-shareholders of a closely-held corporation who have "pocketed" its assets may be subject to personal liability for improper distribution of dividends (*see* ¶ *7:142*). That there was never any formal declaration of dividend is immaterial. [See *Oilwell Chemical & Materials Co. v. Petroleum Supply Co.* (1944) 64 CA2d 367, 373, 148 P2d 720, 723]

b. [7:8] **Disguised ("constructive") dividends:** The substance, rather than the form, of the payment determines whether it is subject to regulation as a "distribution to shareholders."

To the extent that any such payment is found to be without consideration, or for an *inadequate* consideration, it will be treated as a disguised ("constructive") dividend. Typical examples:

• Sale of corporate assets to a shareholder for less than their fair value (i.e., the excess value over the amount paid constitutes a "disguised dividend" to the shareholder).

• Excessive rent paid by the corporation for lease of a shareholder's property (the excess over fair rental value constitutes a "disguised dividend" to the shareholder-lessor).

• Salaries paid to a shareholder in excess of the fair value of the shareholder's services to the corporation. [*Kohn v. Kohn* (1950) 95 CA2d 708, 715, 214 P2d 71, 75 (collecting cases); *see* ¶ *2:106 ff., 7:191 ff.*]

• Amounts paid by the corporation to discharge a shareholder's indebtedness to a third party.

- Funds transferred from one corporation to another to discharge debts owed to or by shareholders. [*Mills v. I.R.S.* (4th Cir. 1988) 840 F2d 229, 235]

- "Principal" and "interest" payments to a shareholder where there is no *bona fide* corporate indebtedness to such shareholder.

(1) [7:9] **Compare—unequal distributions:** The issue of "disguised dividends" may also arise where payments have been made to some shareholders and not others. The others may claim such payments represented a division of profits and hence must be distributed among the shares equally (after payment of the claims of creditors and preferred stockholders, of course); *see ¶ 7:79*.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 7-B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki ‘Vicki’ Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 7. Dividends and Other Distributions

B. Restrictions on Distributions to Shareholders

1. [7:11] Background
2. [7:12] Overview of Tests and Restrictions
    a. [7:13] Compare—liquidation distributions
    b. [7:14] Compare—dividends on partly-paid shares
    c. [7:15] Compare—nonstatutory restrictions
    d. [7:18] Exception for corporate broker-dealers
3. Determinations Under Retained Earnings and Assets/Liabilities Tests
    a. [7:21] Retained earnings test
        (1) [7:22] “Preferential dividends arrears amount”
            (a) [7:23] “Cumulative dividends in arrears”
        (2) [7:24] Special computation for share repurchases
    b. [7:27] Assets/liabilities test
        (1) [7:28] “Preferential rights amount”
        (2) [7:29] Special computation re share repurchases
        (3) [7:30] Special rule re debt contingent upon ability to make distributions
    c. [7:33] Determination of retained earnings, assets and liabilities—GAAP not required
        (1) [7:34] Comment
    d. [7:35] Payment within 120 days required
        (1) [7:36] Special rule re debt distributions
            (a) [7:37] Ordinarily exempt from registration/qualification
4. [7:42] Insolvency Restriction
    a. [7:43] Tested by “cash-flow”—not “bankruptcy”—insolvency
    b. [7:43.1] GAAP determination not required
    c. [7:44] Application
    d. [7:45] Fact questions
    e. [7:46] Evidence
5. [7:54] Exception for Insurance-Funded Redemptions or Repurchases
    a. [7:55] Compare—proceeds insufficient to fund buy-back
    b. [7:56] Compare—voluntary redemptions of deceased shareholder's stock
6. Exception for Investment Companies and Real Estate Investment Trusts
    a. [7:58] Share redemptions at option of shareholder
    b. [7:59] Dividends to maintain tax status

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[7:10] To protect creditors and preferred shareholders against dissipation of corporate assets, the Corporations Code imposes various restrictions on corporate distributions to shareholders.

1. [7:11] **Background:** At one time, shareholder distributions could be paid only from certain types of *surplus*, and never out of "stated capital." The modern approach eliminates the concepts of "capital" and "surplus" (along with the related concepts of "par value" and "no-par value" shares) as restrictions on the source of lawful dividends.

Additionally, California liberalized and simplified its long-standing restrictions on corporate distributions in order to bring California law more in conformity with both the laws of other states and the laws governing limited liability companies and limited partnerships.

2. [7:12] **Overview of Tests and Restrictions:** A corporation is prohibited from making any distributions to its shareholders unless the board of directors determines *in good faith* that the distribution meets either the *retained earnings test* (*¶ 7:21 ff.*) *or* the *assets/liabilities test* (*¶ 7:27 ff.*). [Corps.C. § 500(a)]

In addition to meeting either of these tests, the distribution must not impair the corporation's ability to pay its debts as they mature ("insolvency" restriction, *¶ 7:42 ff.*). [Corps.C. § 501]

a. [7:13] **Compare—liquidation distributions:** Different statutory limitations apply to *liquidating* distributions. [Corps.C. § 508—statutory restrictions on non-liquidating distributions do not apply to involuntary and voluntary dissolutions; *Clark v. S&J Advertising, Inc.* (ED CA 2019) 611 BR 669, 682—Corps.C. § 500 requirements do not apply to dissolution proceedings under Corps.C. § 1900; *see* *¶ 8:944 ff.*]

b. [7:14] **Compare—dividends on partly-paid shares:** If any shares outstanding are not fully paid (e.g., balance owing on subscription price), there are additional dividend restrictions: Dividends can be paid on such shares only in proportion to the consideration actually received by the corporation at the time of the dividend distribution (i.e., if only half the subscription price has been received, only half the dividends otherwise distributable can be paid). [Corps.C. § 409(d); *¶ 3:322*]

c. [7:15] **Compare—nonstatutory restrictions:** The above statutory limitations (¶ 7:10) are not exclusive. The Corporations Code specifically authorizes "*additional* restrictions upon the declaration of dividends or the purchase or redemption of a corporation's own shares by provision in the articles or bylaws or in any indenture or other agreement entered into by the corporation." [Corps.C. § 505 (emphasis added)]

[7:16] Such limitations are often contained in the corporation's articles. (For example, if the articles create a class of preferred stock, the articles may limit dividends on the common; *see* *¶ 3:92*.) Alternatively, such limitations may be contained in bonds, notes or other debt instruments issued by the corporation; or simply imposed by contractual agreements with a lender. In the case of a statutory close corporation, dividend restrictions may also be imposed in the shareholders agreement (*see* *¶ 3:243*).

➪ [7:17] ***PRACTICE POINTER:*** The terms of such additional, nonstatutory restrictions may be more stringent than the statutory provisions discussed below (¶ 7:21 ff.). Therefore, before advising management as to any proposed distribution to shareholders, be sure to check the articles and bylaws, the terms of any bonds or debentures issued by the corporation —and particularly any *loan and credit agreements* with banks or other lenders.

d. [7:18] **Exception for corporate broker-dealers:** Neither the retained earnings nor the assets/liabilities test applies to corporations licensed as broker-dealers so long as they comply with the Financial Protection and Innovation (formerly Business Oversight) Commissioner's and SEC's net capital maintenance rules. [Corps.C. § 500(f)]

[7:19 - 7:20] ***Reserved.***

3. Determinations Under Retained Earnings and Assets/Liabilities Tests

a. [7:21] **Retained earnings test:** To meet this test, retained earnings immediately prior to the distribution must equal or exceed the amount of the distribution *plus* the "preferential dividends arrears amount" (¶ 7:22). [Corps.C. § 500(a)(1)]

(1) [7:22] **"Preferential dividends arrears amount"** means the amount of "cumulative dividends in arrears" (*see* *¶ 7:23*) on all shares having a preference with respect to payment of dividends over the shares with respect to which the distribution

is being made. However, if the corporation's articles allow a distribution without regard to a preferential dividends arrears amount, the preferential dividends arrears amount is zero. [Corps.C. § 500(b); see Corps.C. § 402.5(c)]

(a) [7:23] **"Cumulative dividends in arrears"** means only cumulative dividends that have not been paid as required on a scheduled payment date as set forth in (or determined pursuant to) the corporation's articles, regardless of whether those dividends were declared prior to the scheduled payment date. [Corps.C. § 163.1]

(2) [7:24] **Special computation for share repurchases:** Where a corporation has contracted to repurchase its own shares, a charge or reserve is usually made against retained earnings at the time the contract is entered into. The amount of *all such charges* is added back in determining the lawfulness of the corporation's payments *under the particular repurchase contract*. [Corps.C. § 500(b); *see* ¶ *7:136.2*]

[7:25 - 7:26] ***Reserved.***

b. [7:27] **Assets/liabilities test:** If the corporation has no or inadequate retained earnings to cover the distribution, the distribution may still be lawful so long as the corporation's assets, immediately after the distribution, equal or exceed total liabilities *plus* the "preferential rights amount" (¶ 7:28). [Corps.C. § 500(a)(2)]

(1) [7:28] **"Preferential rights amount"** is the amount that would be needed, if the corporation dissolved at the time of the distribution, to satisfy the preferential rights, including accrued but unpaid dividends, of other shareholders upon dissolution that are superior to the rights of shareholders receiving the distribution. However, if the corporation's articles allow a distribution without regard to any preferential rights, the preferential rights amount is zero. [Corps.C. § 500(b); see Corps.C. § 402.5(c)]

(2) [7:29] **Special computation re share repurchases:** In determining the lawfulness of a distribution made to repurchase the corporation's own shares, the principal amounts owed by the corporation under any applicable share repurchase contracts are excluded from the corporation's liabilities. [Corps.C. § 500(b)]

(3) [7:30] **Special rule re debt contingent upon ability to make distributions:** If the terms of any corporate indebtedness provide that principal and interest may be paid *only to the extent that a distribution to shareholders could lawfully be made* under Corps.C. § 500 (*see* ¶ *7:10 ff.*), such indebtedness (including indebtedness issued as a distribution, ¶ *7:36*) is not a liability for purposes of the asset/liabilities test. [Corps.C. § 500(e)(1)]

(*Note:* Such "contingent debt" is usually issued only to shareholders.)

[7:31 - 7:32] ***Reserved.***

c. [7:33] **Determination of retained earnings, assets and liabilities—GAAP not required:** In determining the amount of retained earnings, assets and liabilities, the board of directors is not constrained by "generally accepted accounting principles" (GAAP). Rather, the board may base its determination (so long as made in *good faith*, ¶ *7:12*) on:

- Financial statements "prepared on the basis of accounting practices and principles that are *reasonable* under the circumstances";

- A "*fair valuation*"; *or*

- Any other method that is "*reasonable* under the circumstances." [Corps.C. § 500(c) (emphasis added)]

Thus, Corps.C. § 500(c) effectively "overrides" Corps.C. § 114, which requires that all financial statement items be determined in accordance with GAAP.

(1) [7:34] **Comment:** These methods appear to allow good faith valuations of appreciated property to create an appreciation surplus (unrealized earnings). While this may permit distributions not allowed by GAAP, it remains to be seen how the accounting profession will treat the distributions (particularly when issuing certified financial statements).

d. [7:35] **Payment within 120 days required:** The effect of a distribution under the retained earnings or assets/liabilities test is measured as of the date the distribution is *authorized* … so long as *payment occurs within 120 days thereafter*. [Corps.C. § 500(d); *see* ¶ *7:60 ff.*]

(1) [7:36] **Special rule re debt distributions:** Where corporate debt is issued as a distribution, *each payment of principal or interest* is treated as a distribution, and the lawfulness of each such payment is determined on the date it is actually *made*. [Corps.C. § 500(e)(2)]

(a) [7:37] **Ordinarily exempt from registration/qualification:** Issuance of debt securities as a shareholder distribution is generally exempt from federal registration and state qualification requirements. [See SA § 2(a)(3) (15 USC § 77b(a)(3)), ¶ *5:29 ff.;* Corps.C. § 25017(a) & (b)—sale means disposition of security "*for value*" (emphasis added)]

However, debt instruments issued in lieu of contractually required dividends (or other distributions) on preferred shares might require qualification as a change in the rights or preferences of outstanding shares (unless an appropriate exemption applies). [See Corps.C. § 25017(a), ¶ *5:195.4a, 8:152.6*; and, e.g., Corps.C. § 25102(e) (exemption for private sales of debt securities)]

➪ [7:38] ***PRACTICE POINTER:*** Corps.C. § 500(e)(2) may prevent the corporation from making timely payments of interest and principal on such debt, and hence renders debt distributions problematic unless the corporation remains financially healthy. To avoid both a potential default under such debt and the possibility of misleading the recipient shareholders, the debt instruments should recite that payment of interest and principal is contingent upon the corporation's ability to make lawful distributions to its shareholders (*see* ¶ *7:30*).

[7:39 - 7:41] ***Reserved.***

4. [7:42] **Insolvency Restriction:** In addition to meeting the retained earnings or assets/liabilities test, the Code imposes a traditional insolvency limitation: No distribution to shareholders may be made if, as a result thereof, the corporation would "likely … be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature." [Corps.C. § 501]

a. [7:43] **Tested by "cash-flow"—not "bankruptcy"—insolvency:** The insolvency restriction on corporate distributions is not a question of whether the corporation would be rendered insolvent in the "bankruptcy" sense (more liabilities than assets). For purposes of Corps.C. § 501, it is sufficient that the distribution would render the corporation insolvent in the "equity" sense (unable to pay its bills as they mature)—i.e., *"cash-flow" insolvency*.

b. [7:43.1] **GAAP determination not required:** The "insolvency" determination (like the retained earnings and assets/liabilities determinations) need not be made in accordance with GAAP. Rather, the determination may be made using "reasonable" accounting practices, fair valuation or any other "reasonable" method (¶ *7:33*). [Corps.C. § 500(c)]

c. [7:44] **Application:** A corporation may be insolvent in the equity ("cash-flow") sense even if it meets the retained earnings test (¶ *7:21 ff.*) and/or the assets/liabilities test (¶ *7:27 ff.*). This may occur where, e.g., a cash distribution leaves the corporation with insufficient cash or other *liquid* assets to pay its debts as they mature.

d. [7:45] **Fact questions:** Whether the distribution will render the corporation "unable to meet its liabilities," and whether liabilities are "otherwise adequately provided for," are fact questions to be determined objectively in each case. If the board's judgment is wrong, the directors may face personal liability for unlawful dividends; *see* ¶ *7:142*. [See *Flynn v. California Casket Co.* (1951) 105 CA2d 196, 205-206, 233 P2d 131, 136-137]

e. [7:46] **Evidence:** The fact that a corporation is overdue in paying its accounts, and is not presently operating at a profit, is evidence of inability to pay its debts when due. But such evidence by itself is *not conclusive*—i.e., it can be overcome by other evidence tending to show the corporation's ability to pay. [*Flynn v. California Casket Co.* (1951) 105 CA2d 196, 202-204, 233 P2d 131, 134-135]

[7:47 - 7:53] ***Reserved.***

5. [7:54] **Exception for Insurance-Funded Redemptions or Repurchases:** None of the foregoing limitations (¶ 7:10 ff.) on "distributions to shareholders" applies to a corporation's repurchase or redemption of shares of a *deceased* or *disabled* shareholder pursuant to a "buy-back" agreement, provided:

- The amount paid by the corporation is limited to life or disability *insurance proceeds* received by the corporation (net of all premiums paid by the corporation for such insurance); and

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The repurchase or redemption is pursuant to an *agreement* with the shareholder, obligating the corporation to repurchase or redeem such shares on the shareholder's death or disability. [Corps.C. § 503]

a. [7:55] **Compare—proceeds insufficient to fund buy-back:** If the insurance proceeds derived by the corporation (net of the premiums paid by it for such insurance) are *less* than the amount it is obligated to pay under the repurchase or redemption agreement, the limitations of Corps.C. §§ 500 and 501 apply: i.e., distributions made pursuant to the buy-back in excess of insurance proceeds (reduced by premiums paid) must pass either the retained earnings or assets/liabilities test and must not render the corporation "insolvent" (*¶ 7:10 ff.*).

(Comment: The insurance proceeds received by the corporation are offset by its obligation to repurchase the shares. Thus, its net worth is enhanced only by the amounts recovered for its premium costs.)

b. [7:56] **Compare—voluntary redemptions of deceased shareholder's stock:** If the corporation is insolvent in the bankruptcy sense (liabilities exceed assets), a *voluntary* redemption of shares may be treated as a *voidable transaction* (see Civ.C. §§ 3439.02, 3439.04)—i.e., the fact that the redemption is funded by insurance on the shareholder whose shares are being redeemed does not insulate it from attack. [Corps.C. § 506(d)]

In contrast, where the corporation was under an antecedent obligation to *purchase* the shares, there would be fair consideration for the payment and thus no voidable transaction. [See Civ.C. § 3439.03]

[7:57] ***Reserved.***

6. Exception for Investment Companies and Real Estate Investment Trusts

a. [7:58] **Share redemptions at option of shareholder:** None of the above limitations (¶ 7:10 ff.) apply to amounts paid by a "registered open-end investment company" for shares redeemed at the option of the shareholder, provided the investment company is registered as such under the Investment Company Act of 1940 (15 USC § 80a-1 et seq.). (The extensive federal regulation is considered adequate to protect the interests of any creditors or preferred shareholders.) [Corps.C. § 504(b)]

b. [7:59] **Dividends to maintain tax status:** Moreover, the balance sheet limitations of Corps.C. § 500 (¶ *7:18*) do not apply to dividends declared by a "regulated investment company" (as defined in IRC § 851) or a "real estate investment trust" (as defined in IRC § 856) to the extent necessary to maintain its status as such. (But the Corps.C. § 501 insolvency limitation still applies to such distributions.) [Corps.C. § 504(a)]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 7-C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 7. Dividends and Other Distributions

C. Timing of Distributions

1. [7:61] Time of Dividend and Determination of Tests
   a. [7:62] Effect
   b. [7:63] Comment
   c. [7:63.1] Payment and record date determinations
   d. [7:64] No revocation of dividends
   e. [7:64.1] Compare—debt distributions
2. [7:65] Time of Repurchase or Redemption
   a. [7:66] Effect
      (1) [7:66.1] Example
   b. [7:67] Compare—sinking fund payments
      (1) [7:69] Effect
   c. [7:70] Compare—issuance of debt security for shares
      (1) [7:71] "Debt security" defined
      (2) [7:72] Comment
   d. [7:73] Compare—issuance of other debt instruments for shares
      (1) [7:75] Exception for holders in due course

[7:60] For purposes of applying the various tests discussed above (¶ 7:10 ff.) and determining the legality of any proposed distribution, the Code sets forth various requirements regarding *timing* of the distributions.

1. [7:61] **Time of Dividend and Determination of Tests:** A dividend is deemed made when *declared* by the board of directors. [Corps.C. § 166]

The lawfulness of the dividend under the retained earnings test (¶ *7:21 ff.*) and the assets/liabilities test (¶ *7:27 ff.*) is likewise measured as of the date the dividend is declared ("the date the distribution is authorized") … *so long as payment occurs within 120 days thereafter*. [Corps.C. § 500(d); *see* ¶ *7:35*]

a. [7:62] **Effect:** If the dividend is lawful when declared, it is lawful when paid so long as payment occurs within 120 days. Thus, adverse financial changes occurring during the 120-day period do not render the dividend unlawful.

b. [7:63] **Comment:** This allows the directors to determine with greater certainty the propriety of the dividend at the time they authorize it. It also protects them from possible liability for unlawful dividends if the corporation's financial position deteriorates before the dividend is actually paid.

c. [7:63.1] **Payment and record date determinations:** So long as payment of the dividend is made within 120 days after it is declared, the actual payment date rests within the sound discretion of the board. However, the *record date* for determining which shareholders are entitled to the dividend must be *within 60 days* prior to the payment date. [See Corps.C. § 701(a), ¶ *7:86 ff.*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

d. [7:64] **No revocation of dividends:** A dividend once declared constitutes a *debt* owing to the shareholders and cannot be revoked; *see ¶ 7:85*.

e. [7:64.1] **Compare—debt distributions:** *See ¶ 7:36*.

2. [7:65] **Time of Repurchase or Redemption:** A distribution to shareholders by way of repurchase or redemption of their shares is deemed to occur only on the date of *payment*; i.e., when the cash or property is actually transferred by the corporation to the shareholders. This is true even if the payment is pursuant to a contract entered into by the corporation on an earlier date. [Corps.C. § 166; *Maudlin v. Pacific Decision Sciences Corp.* (2006) 137 CA4th 1001, 1010, 40 CR3d 724, 729-730]

a. [7:66] **Effect:** The lawfulness of the repurchase or redemption is tested at the time the contract is performed, not when it was entered into. [*Maudlin v. Pacific Decision Sciences Corp.* (2006) 137 CA4th 1001, 1010, 40 CR3d 724, 729-730]

If there have been adverse financial changes since the contract was made, it may be unlawful for the corporation to perform its contract to repurchase or redeem shares. However, the corporation's obligation is merely *suspended* for so long as the promised distributions would violate the statutory restrictions (*¶ 7:10 ff.*). (Under contract law, the corporation's obligation is not excused or discharged unless or until its inability to satisfy the statutory restrictions becomes *permanent* or renders performance *materially more burdensome*.) [*Maudlin v. Pacific Decision Sciences Corp.*, supra, 137 CA4th at 1017, 40 CR3d at 735]

(1) [7:66.1] **Example:** XYZ Corp. contracted to repurchase S's shares over a period of several years. XYZ was solvent when the contract was executed, but its financial picture deteriorated thereafter and it became insolvent. It is improper for XYZ to make any further payments to S. Even though S has a contract claim against XYZ, *the claim is deemed to be that of a shareholder* and, hence, subordinate to claims of corporate creditors. [See *McConnell v. Estate of Butler* (9th Cir. 1968) 402 F2d 362, 366-367]

b. [7:67] **Compare—sinking fund payments:** The articles may require the corporation to set aside funds annually for the purpose of future redemptions of all or some part of its outstanding preferred shares (*see ¶ 3:137*). The articles may require that such funds be paid over to an independent trustee; or may simply require that the funds be physically segregated by the corporation and held in trust for redemption. The articles usually specifically permit foregoing the sinking fund payments if making them would violate the balance sheet limitations discussed above (¶ 7:21 ff.).

Where payments are made into a sinking fund for redemption of its preferred shares, the "distribution" is deemed made as of the date of the sinking fund payment (whether deposited with a trustee or transferred to a segregated account). [Corps.C. § 166]

[7:68] ***Reserved.***

(1) [7:69] **Effect:** The legality of the sinking fund payments is not affected by later financial changes. Monies set aside for redemption or repurchase of preferred shares in earlier years may be lawfully used for those purposes, even if the corporation's present financial situation would not permit such distributions.

c. [7:70] **Compare—issuance of debt security for shares:** Where a corporation repurchases or redeems its shares by exchanging a "debt obligation that is a security," the distribution is deemed made at the time of the *exchange* (rather than later when payments are made on the debt). [Corps.C. § 166]

(1) [7:71] **"Debt security" defined:** The term "debt security" refers to a debt obligation of an issuer that is a security as defined in Comm'l C. § 8102—i.e., it is one of a class or series of obligations, shares, participations or other interests in an issuer or in property or in an enterprise of an issuer (or divisible by its terms into a class or series), evidenced by bearer or registered certificates or transferable by registration on the issuer's books, and either is of a type dealt in on securities exchanges or markets or is a medium for investment that by its terms expressly provides it is a security governed by Division 8 ("Investment Securities") of the Commercial Code. [See Comm'l C. § 8102(a)(15)]

(2) [7:72] **Comment:** Thus, the legality of a share repurchase or redemption can be determined at the time the corporation *issues* the debt security in exchange for shares. This facilitates substitution of corporate debt for some of its equity by allowing the former shareholders to receive payments under the debt security without potential liability for receipt of unlawful distributions.

d. [7:73] **Compare—issuance of other debt instruments for shares:** If the promissory note or other debt instrument given in exchange for shares does *not* qualify as "a debt obligation that is a security" (¶ 7:71), different rules apply: The legality of

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

payments made under such notes depends on the corporation's financial status at the time of *payment* (not at time of issuance). [Corps.C. § 166]

[7:74] Thus, if the corporation cannot meet the retained earnings or assets/liabilities test, or has become insolvent, the note may be unenforceable because payment would constitute an unlawful "distribution" to the former shareholder.

➪ [7:74.1] ***PRACTICE POINTER:*** To further protect the selling shareholder whose shares are being redeemed or repurchased by the corporation *with payment deferred*, consider getting the other remaining shareholders to *guarantee* the corporation's payment. This arrangement is especially useful in closely-held corporations, and may be built into the buy-out agreement (*see ¶ 3:201*).

(1) [7:75] **Exception for holders in due course:** However, a holder in due course who purchases a *negotiable* instrument (whether or not a "debt security") *without notice* that it was issued for shares, can enforce it against the corporation—and so can anyone later acquiring it from such a holder—notwithstanding the distribution limitations discussed above (*¶ 7:10 ff.*). [Corps.C. § 511]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 7-D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 7. Dividends and Other Distributions

D. Procedure Re Distributions to Shareholders

- 1. Declaration of Dividends
  - a. [7:76] Discretion of board
    - (1) [7:77] Exception when articles make dividends mandatory
    - (2) [7:78] Good faith as limitation on board's discretion
      - (a) [7:79] Example
      - (b) [7:80] Comment
    - (3) [7:81] Compare—fiduciary obligation owed by controlling shareholders
      - (a) [7:82] Example
  - b. [7:83] Board action required
    - (1) [7:84] Delegation of authority
  - c. [7:85] Board may not revoke
  - d. [7:86] Determining shareholders entitled to receive dividends
    - (1) [7:87] Record date fixed by board
    - (2) [7:90] No record date fixed by board
    - (3) Effect of share transfers after record date
      - (a) [7:91] To whom dividend payable by corporation
      - (b) [7:92] Rights between transferor and transferee
        - 1) [7:93] "Ex dividend"
        - 2) [7:94] Compare—title transferred before record date
  - e. [7:97] Determining date for payment
  - f. [7:99] Notice to shareholders re dividend source not required
- 2. [7:100.1] Redemption or Repurchase of Shares
  - a. [7:101] Redemption
    - (1) [7:102] Right must be reserved in articles
    - (2) [7:103] Redemption at option of corporation
      - (a) [7:105] Purpose for redemption
      - (b) [7:107] Limitation—no redemption of common stock
        - 1) [7:108] Comment
      - (c) [7:109] Role of "sinking fund" provisions
        - 1) [7:110] Comment
      - (d) Procedure for redemption by corporation
        - 1) [7:111] Authorization by board
        - 2) [7:112] Partial redemptions

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a) [7:114] Limits on directors' discretion
b) [7:114.1] Comment
3) [7:115] Notice ("call")
a) [7:116] Contents
b) [7:117] Publication
c) [7:118] Mailing
4) [7:120] Deposit of redemption price
5) [7:121] Effect of "call" and deposit
6) [7:123] Corporation cannot revoke
(3) [7:124] Redemption at option of preferred shareholders
(a) [7:125] Purpose
(b) [7:126] Option to holders individually or as class
(c) [7:127] Compare—mutual fund shareholders
b. [7:128] Repurchase of shares
(1) [7:129] Corporation's power to repurchase own shares
(2) [7:130] Selective repurchases permissible
(a) [7:131] Compare—redemptions
(b) [7:132] Compare—repurchases through employee stock plans
(3) [7:133] Valid corporate purpose required
(a) [7:134] Compare—purpose to perpetuate management ("greenmail")
(4) [7:135] Other requirements re share repurchases
(a) [7:136] "Shareholder distribution" limitations
1) [7:136.1] Liabilities exclude share repurchase obligation
2) [7:136.2] Retained earnings recomputed
3) [7:136.3] Subordination to creditors' claims
(b) [7:137] Disclosures may be required
(c) [7:138] Reporting requirements
1) [7:138.1] Private action for violations?
(d) [7:138.6] Enforceability of negotiable instrument given in payment of shares
c. [7:139] Status of repurchased or redeemed shares
(1) [7:140] Where articles absolutely prohibit reissuance
(2) [7:140.5] Where articles prohibit only reissuance *as shares of same series*
(3) [7:140.10] Filing amendment to articles; shareholder approval *not* required

1. Declaration of Dividends

a. [7:76] **Discretion of board:** The payment of dividends rests within the sound discretion of the board of directors. Shareholders have no "right" to dividends even if adequate funds are available. The directors alone have the power to determine if, when and how much of a dividend will be paid. [*Richards v. Pacific Southwest Discount Corp.* (1941) 44 CA2d 551, 558, 112 P2d 698, 702]

(1) [7:77] **Exception when articles make dividends mandatory:** The only exception is where the articles expressly make dividends mandatory on one or more classes of shares: e.g., provisions requiring payment of dividends on preferred shares whenever the corporation has sufficient earnings (e.g., "payment mandatory if earned"; *see* ¶ *3:95*). But such provisions are quite rare.

(Of course, even where such provisions exist, the statutory limitations discussed above (¶ 7:12 ff.) would still apply; e.g., they would prevent payment of dividends if the corporation were insolvent or had no retained earnings, etc.)

(2) [7:78] **Good faith as limitation on board's discretion:** The board's discretion as to whether to pay dividends, and how much to pay, must be exercised in good faith. If the directors act "fraudulently" or in "bad faith," they may be held personally liable to shareholders injured thereby. [*Richards v. Pacific Southwest Discount Corp.* (1941) 44 CA2d 551, 558, 112 P2d 698, 702]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [7:79] **Example:** Directors who vote excessive "salaries" to themselves or controlling shareholders, while refusing to declare dividends, may be personally liable to the minority shareholders. The court may find that all or some part of the salaries were "disguised dividends" (*see* ¶ *7:9*) and that the other shareholders were entitled to part thereof. [*De Martini v. Scavenger's Protective Ass'n* (1935) 3 CA2d 691, 698, 40 P2d 317, 320]

(b) [7:80] **Comment:** Courts are generally very reluctant to second-guess the decisions of directors re payment of dividends. There are simply too many business factors involved. A *strong* showing of "bad faith" or "fraud" is required.

(3) [7:81] **Compare—fiduciary obligation owed by controlling shareholders:** Controlling shareholders owe a fiduciary duty to minority shareholders not to exercise their control of the corporation so as to enrich themselves at the expense of the minority (*see* ¶ *6:335*). Arguably, therefore, even if minority shareholders have no "right" to dividends, they may have a cause of action against a controlling shareholder who causes the corporation to adopt a dividend policy designed to serve the controlling shareholder's own personal interests, at the expense of the minority.

(a) [7:82] **Example:** A controlling shareholder seeks to purchase the shares of minority shareholders at a deflated price. They refuse to sell. In an attempt to "freeze them out," he causes the board of directors to stop paying dividends, although ample funds are available. The controlling shareholder may be subject to liability for breaching his fiduciary duty to the other shareholders.

b. [7:83] **Board action required:** The power to declare dividends is one of the unique functions of the board itself, and requires action by the board as a whole. Such action normally consists of a resolution declaring a dividend and authorizing its payment (although it may also be taken by written consents executed by every member of the board).

(1) [7:84] **Delegation of authority:** While some functions of the board can be delegated to a board committee, the authority to declare dividends cannot be; i.e., action by the full board is required (*see* ¶ *6:184*).

However, if the articles establish, or the full board has previously set, the rate, periodic amount or range within which dividends may be declared, the board may delegate to a board committee the power to determine when and how much shall be paid. In such cases, the declaration is viewed as within the discretion previously exercised by the full board. [Corps.C. § 311(f)]

c. [7:85] **Board may not revoke:** Once the board of directors has lawfully declared a dividend, it may not revoke it or withhold distribution. The declaration creates a *debt* owing to the shareholders entitled to its payment (*see* ¶ *7:91*). Therefore, the dividend cannot be rescinded without the consent of each such shareholder. [*Meyers v. El Tejon Oil & Refining Co.* (1946) 29 C2d 184, 188, 174 P2d 1, 3]

d. [7:86] **Determining shareholders entitled to receive dividends:** In order to determine the shareholders entitled to receive payment of the dividend, the board of directors may fix a "record date." If the board fails to do so, the Code automatically fixes the date for such determination:

(1) [7:87] **Record date fixed by board:** If the board fixes a "record date" for dividend payment, the date chosen must be within 60 days before the dividend is to be paid. [Corps.C. § 701(a)]

[7:88 - 7:89] ***Reserved.***

(2) [7:90] **No record date fixed by board:** If the board fails to fix a "record date" for determining the shareholders entitled to the dividend, the Code does so: The record date is the close of business on the day the board *declares* the dividend; or 60 days before the dividend is made payable by the board, whichever is later. That is, unless payment is delayed for more than 60 days following declaration, the record date will be the date the board declares the dividend. [Corps.C. § 701(b)(3)]

(3) Effect of share transfers after record date

(a) [7:91] **To whom dividend payable by corporation:** The corporation is required to pay the dividend to the shareholders of record, determined as of the "record date." [Corps.C. § 701(d)]

Thus, the corporation's obligation to pay the dividends to shareholders of record as of the record date is not affected by share transfers occurring between the record date and the actual date of distribution. Nor is it affected by contractual rights that arose in the interim between the shareholder of record and a buyer of the shares.

(b) [7:92] **Rights between transferor and transferee:** One who purchases shares after the "record date" has no right to dividends declared but not yet paid on the shares purchased, unless the selling shareholder *expressly agrees* to assign the

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

dividend rights to the buyer. [*Cates v. Consolidated Realty Co.* (1914) 25 CA 531, 532-533, 144 P 301, 302—execution sale did not convey right to receive dividends declared before sale occurred]

1) [7:93] **"Ex dividend":** Shares sold after the record date are referred to as "ex dividend" to reflect the fact that the selling shareholder retains the dividend. Theoretically at least, they sell for a lesser price to reflect this fact.

2) [7:94] **Compare—title transferred before record date:** But if title to the shares was transferred *before* the record date, the purchaser is entitled to the dividend, even if the shares have not yet been transferred on the corporate records. As long as the *transfer* was complete before the record date, delay in effecting transfer on the corporation's records should not affect the purchaser's right to the dividend vis-à-vis the seller. (However, the *issuer* should be able to rely upon the record date list of shareholders, and should not be required to pay the dividend to persons who are not shareholders of record as of the record date.) [See Corps.C. § 701(d); see also M. Rhodes, *Transfer of Stock*§ 22:11 (7th ed. 2005-2006, 2020 Supp.)—absent authenticated request from record owner, most transfer agents refuse requests by other persons to pay dividends to any person other than registered owner]

In such cases, the purchaser-transferee would have the right to recover from the seller-transferor any dividends received after the record date.

[7:95] ***Reserved.***

➪ [7:96] ***PRACTICE POINTER:*** If you represent the corporation in a situation in which conflicting demands are made with respect to dividends and the amounts involved are material, consider filing an *interpleader action* against the parties asserting the conflicting claims to the dividend. This avoids the risk of the corporation incurring liability if it pays the wrong party.

e. [7:97] **Determining date for payment:** So long as payment of the dividend is made within 120 days after it is declared (*see ¶ 7:61*), the actual payment date rests within the sound discretion of the board of directors. Normally, it is set within 10 to 30 days following the "record date," so as to allow a reasonable period for preparation and implementation of the dividend distributions.

[7:98] ***Reserved.***

f. [7:99] **Notice to shareholders re dividend source not required:** At one time, if a dividend was paid from sources other than retained earnings, the corporation had to notify the recipient shareholders from what source it was paid. However, this is no longer required.

[7:100] ***Reserved.***

2. [7:100.1] **Redemption or Repurchase of Shares:** Corporations with excess cash often reacquire their outstanding shares, especially when they can be obtained at "discount" prices. As a result, the corporation's *per share* earnings go up because there are fewer shares outstanding. This in itself can help to increase the value of the stock. Of course, the corporation's capital (net worth) is reduced by the amount paid to reacquire the shares. But so long as the price paid is no more than the *existing* per share "net book value" (i.e., the net book value of the corporate assets, *¶ 1:110*, minus liabilities, divided by the number of outstanding shares), it will not reduce the per share net book value of the remaining shares.

a. [7:101] **Redemption:** A "redemption" involves the corporation's calling in outstanding shares pursuant to a right to do so and on terms provided in the articles of incorporation. (The main distinction between a "redemption" and a "repurchase" is that a redemption must be provided for in the articles, whereas share repurchases can be negotiated case by case; *see ¶ 7:128*.)

Amounts paid by the corporation to redeem or repurchase its shares are treated as "distributions to shareholders," and are thus subject to the restrictions discussed above (*¶ 7:10 ff.*). [Corps.C. §§ 166, 402(d)]

(1) [7:102] **Right must be reserved in articles:** There is no such thing as an implied or "inherent" right to redeem shares. Shares are redeemable only where the right to redeem was *expressly* provided for in the corporation's articles when the shares were issued. [Corps.C. § 402(a)]

The articles may authorize redemption *either* at the option of the corporation (¶ 7:103 ff.), or at the option of a preferred shareholder under certain circumstances (¶ 7:124 ff.).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [7:103] **Redemption at option of corporation:** Except as stated below (¶ 7:107), the articles may authorize the corporation, at its option, to redeem any class or series of shares, in whole or in part. [Corps.C. § 402(a)]

But where the articles authorize *partial* redemptions, they must also state the method by which the shares to be redeemed are to be selected. [Corps.C. § 402(b); *see ¶ 7:112*]

[7:104] ***Reserved.***

(a) [7:105] **Purpose for redemption:** The usual purpose for a corporation's redeeming shares is to eliminate shares having dividend or other preferences, for the benefit of the common shares. The decision is usually based on economic grounds: e.g., getting rid of a high dividend rate on the preferred when less expensive financing is available.

[7:106] Also, in closely-held corporations, shares of a deceased or retiring shareholder are often redeemed in order to preserve the proportionate interests of the remaining shareholders, or to effectuate a "buy-sell" agreement; *see ¶ 3:199*.

(b) [7:107] **Limitation—no redemption of common stock:** However, common shares may not be issued as "redeemable," nor may they be redeemed, *unless* another series of common shares is outstanding that is *not* subject to redemption. [Corps.C. § 402(c); *see ¶ 3:132*]

1) [7:108] **Comment:** The purpose of this limitation, of course, is to prevent the board from eliminating the shareholders who can elect or remove them.

(c) [7:109] **Role of "sinking fund" provisions:** Articles authorizing the corporation to redeem outstanding shares may also contain "sinking fund" provisions, requiring the corporation to set aside a part of its earnings each year to accumulate the necessary funds for redemption. [Corps.C. § 402(d); *see ¶ 7:67*]

1) [7:110] **Comment:** Such provisions do not make redemption mandatory, but do create a strong incentive for the corporation to redeem … since management cannot use the funds for any other purpose.

(d) Procedure for redemption by corporation

1) [7:111] **Authorization by board:** Where shares are redeemable at the option of the corporation, exercise of that option lies entirely within the discretion of the board of directors (to be exercised by formal resolution).

As with declaring dividends, the authority to call shares for redemption *cannot be delegated* by the board (except that if the articles or the full board establishes the price and terms for redemption, authority to call the shares may be delegated to a board committee). [Corps.C. § 311(f); ¶ 6:184]

2) [7:112] **Partial redemptions:** If the articles expressly so provide, the corporation may redeem "part of any class or series of shares." [See Corps.C. § 402(a), (b)]

[7:113] If the articles authorize such partial redemptions, they must specify the *method* of selecting the shares to be redeemed, which may be either:

• Pro rata redemption within the series or class; or

• Selection by lot; or

• Some other specified manner. [See Corps.C. § 402(b)]

a) [7:114] **Limits on directors' discretion:** Although Corps.C. § 402(b) indicates that the selection of which shares are to be redeemed may be left to the directors' discretion, the Secretary of State will *not* file an articles provision permitting partial redemption and leaving the selection *entirely* to the directors. Rather, the articles may only allow the directors to choose the *method* or *procedure* for the selection. Such method must give all shareholders of the same class equal opportunity and equal treatment (e.g., selection by lot, or pro rata redemption).

The Secretary's position is based on Corps.C. § 400(b), which grants *equal* redemption rights to all shares of the same class.

b) [7:114.1] **Comment:** Furthermore, leaving the selection entirely to the board of directors creates the possibility that they may utilize selective redemptions to rid themselves of dissident shareholders (ordinarily preferred shareholders, since common shares are generally not subject to redemption; *¶ 7:107*).

However, the directors are subject to the fiduciary duties discussed earlier (*¶ 6:243*) in making such redemptions … so that such redemption could not be used for "fraudulent" or "bad faith" purposes. [See, e.g., *Zahn v. Transamerica Corp.* (3rd Cir. 1947) 162 F2d 36, 46; and *Speed v. Transamerica Corp.* (3rd Cir. 1956) 235 F2d 369, 373-374]

3) [7:115] **Notice ("call"):** After redemption has been authorized by the board, the corporation must give notice of the redemption. The articles may specify the contents of such notice and the manner in which it is to be given. If not, the "call" must be given as follows:

a) [7:116] **Contents:** The notice of redemption must set forth all of the following:

• The class or series of shares, or part of any class or series of shares, being redeemed;

• The date fixed for redemption;

• The redemption price; and

• The place at which the shareholders may obtain payment upon surrender of their shares (but this is not required if the corporation has adopted uncertificated shares, *¶ 5:472*). [Corps.C. § 509(b)(1)-(4)]

b) [7:117] **Publication:** The notice must be published in a newspaper of general circulation in the county in which the corporation's principal executive office is located, at least once a week for two successive weeks, commencing at least 20 (and not more than 60) days before the date fixed for the redemption. [Corps.C. § 509(b)]

c) [7:118] **Mailing:** In addition, notice *should* be mailed (within the same 20-60 day period provided for publication) to each shareholder of record of shares being redeemed … although failure to mail individual notice does *not* invalidate the redemption. [Corps.C. § 509(c)]

[7:119] The shareholders' identity is determined as of the mailing date or "record date" fixed in accordance with Corps.C. § 701 (*see ¶ 7:86*). The notice is to be sent to their addresses shown on the corporate records; or if none, in care of the principal executive office of the corporation. [Corps.C. § 509(c)]

4) [7:120] **Deposit of redemption price:** To complete the redemption, the corporation may:

• Pay or deposit the redemption price in the manner provided in its articles; *or*

• Deposit sufficient funds to cover the redemption price with any bank or trust company in California on or before the date fixed for the redemption, together with irrevocable instructions to pay the price to the holders upon surrender of their share certificates (or, in the case of uncertificated shares, to the persons named in an officer's certificate). [Corps.C. § 509(d)]

5) [7:121] **Effect of "call" and deposit:** Shares are redeemed automatically by a proper call and deposit of the redemption price. The redemption is complete even if a shareholder refuses to accept the deposit. [Corps.C. § 509(d)]

[7:122] After such a call and deposit, the shares called are no longer "outstanding" (whether surrendered to the corporation or not). The holders of such shares cease to be "shareholders," and have no further rights to dividends or other shareholder rights. Their only right is to receive the redemption price upon surrender of their shares (and, if provided by the articles, any right to convert their shares to common stock that may still exist). [Corps.C. § 509(d)]

6) [7:123] **Corporation cannot revoke:** Once the board has called shares for redemption, the call is irrevocable. The holders of the called shares become creditors of the corporation after the date fixed for redemption, and are entitled to enforce their right of payment to the extent it would be a permissible "shareholder distribution" (under Corps.C. § 500 et seq., ¶ 7:10 ff.). [Corps.C. § 402(d)]

(3) [7:124] **Redemption at option of preferred shareholders:** The articles may provide that the *preferred* shares (but not the common) shall be redeemable at the *option of the holder*, or by majority vote of the shares as a class, "to the extent and upon the happening of one or more specified events …" [Corps.C. § 402(a)]

Thus, the terms and conditions upon which the option is exercisable depend upon the articles. For example, the articles may provide for redemption of the preferred shares after a specified date, or in the event specified assets are sold or refinanced.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [7:125] **Purpose:** This gives the preferred shareholders the right to "put" their shares (sell them back) to the corporation on the terms and conditions stated in the articles. It makes the preferred shares much more attractive, because it assures the holders both a market for their shares, and the price to be received—*provided* the statutory limitations on "shareholder distributions" are met (*see ¶ 7:10 ff.*).

(b) [7:126] **Option to holders individually or as class:** The option may either be granted to each preferred shareholder individually, *or* it may be exercisable only by majority vote of the *class* or series of preferred shares to be redeemed. Again, this depends on the articles provision. [Corps.C. § 402(a)]

(c) [7:127] **Compare—mutual fund shareholders:** The articles of an open-ended investment company (i.e., mutual fund) may provide that its shares are redeemable by the holder. The price must be approximately equal to the holder's proportionate interest in the fund's net worth at the time of redemption. [Corps.C. § 402(a)]

b. [7:128] **Repurchase of shares:** "Repurchase" of shares is distinguished from a redemption in that it is not dependent on rights reserved in the articles of incorporation. Rather, repurchase involves a corporation entering into an *agreement* with one or more of its shareholders to buy back their shares.

Also, whereas the price and terms on which shares are redeemed depends on the articles, a share "repurchase" agreement can be negotiated on whatever terms and at whatever price the parties desire (subject to the limitations discussed below; ¶ 7:129 ff.).

(1) [7:129] **Corporation's power to repurchase own shares:** The corporation's power to repurchase its own shares is implied by law and therefore need not be expressly reserved in the corporation's articles. The Code confers on every corporation (except where its articles provide otherwise) the inherent power to "purchase, redeem, receive, take or otherwise acquire … its own shares." [Corps.C. § 207(d); see also Corps.C. § 2605(d) (SPCs)]

(2) [7:130] **Selective repurchases permissible:** The corporation generally may purchase its shares from whom it pleases; i.e., from some shareholders and not from others. Unless the articles provide otherwise, there is generally no duty to make an offer to all shareholders.

• [7:130.1] **Exception:** A corporation that repurchases shares from a member of a controlling group may have a duty to accord minority shareholders pro rata repurchase rights. [See *Donahue v. Rodd Electrotype Co. of New England, Inc.* (MA 1975) 328 NE2d 505, 518-519, *discussed at ¶ 6:350.1*]

(a) [7:131] **Compare—redemptions:** If the articles reserve to the corporation the option to redeem only *part* of the shares of a certain class or series, the articles must also state the *method* for selecting the shares to be redeemed (Corps.C. § 402(b); *¶ 7:113*). The articles may leave to the directors the choice of an equitable method for selecting the shares to be redeemed, but may not give them complete discretion to make the selection themselves (*see ¶ 7:114*).

(b) [7:132] **Compare—repurchases through employee stock plans:** Employee stock purchase plans typically obligate the corporation to repurchase shares of an employee-shareholder upon termination of their employment. Such repurchase obligations are explicitly authorized by Corps.C. § 408(b) and are excluded from the definition of "distribution to shareholders" (Corps.C. § 166; *see ¶ 7:2 ff.*). But any such repurchase must be expressly determined by a disinterested board of directors to be in the corporation's best interests and not likely to result in insolvency. [Corps.C. § 166; *see ¶ 7:3.5*]

(3) [7:133] **Valid corporate purpose required:** Any share repurchase must be for a bona fide *corporate* purpose. The same "honest business judgment" test applies to share repurchases as to other corporate actions (*¶ 6:245*). Thus, share repurchases will be upheld if the directors make a good faith determination that there was a bona fide *corporate* purpose for the repurchase, and that the terms are fair and reasonable to the corporation.

(a) [7:134] **Compare—purpose to perpetuate management ("greenmail"):** Directors *cannot* use the corporation's funds to pay an excessive price for the shares of dissident shareholders *solely* to perpetuate themselves in management: e.g., buying out the shares of an insurgent threatening a proxy contest or a "raider" threatening a takeover attempt, in order to protect their own jobs. Such use of corporate funds may be held to breach the directors' fiduciary duties to the corporation. [See *Heckmann v. Ahmanson* (1985) 168 CA3d 119, 127, 214 CR 177, 182-183 (*discussed at ¶ 6:247.4*); and *Bennett v. Propp* (Del. 1962) 187 A2d 405, 408-409]

But the purchase might be justified if the threatened takeover jeopardized the interests of the corporation generally. [See *Cheff v. Mathes* (Del. 1964) 199 A2d 548, 553]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(4) [7:135] **Other requirements re share repurchases:** Various other issues may be raised in connection with a corporation's purchases of its own shares:

(a) [7:136] **"Shareholder distribution" limitations:** The restrictions on "distributions to shareholders" apply to amounts paid to repurchase shares—i.e., the retained earnings or assets/liabilities test must be met, and the distributions must not render the corporation "insolvent." [Corps.C. §§ 500, 501, ¶ *7:10 ff.*]

1) [7:136.1] **Liabilities exclude share repurchase obligation:** In measuring the corporation's liabilities, its obligation under share repurchase contracts is not counted—i.e., in determining whether the proposed distribution meets the assets/liabilities test, the principal balance (but not unpaid interest) the corporation owes under share repurchase contracts is *excluded*. [Corps.C. § 500(b), ¶ *7:29*]

2) [7:136.2] **Retained earnings recomputed:** A corporation usually reduces (or "reserves") its retained earnings when it contracts to repurchase its shares (to reflect the fact that a portion of retained earnings will be used to repurchase the shares). However, in determining lawfulness of payments made under the share repurchase contract, retained earnings are refigured. Whatever amounts were previously deducted (up to the balance unpaid under such contracts) are added back in measuring whether there are sufficient retained earnings to support the distribution. [Corps.C. § 500(b), ¶ 7:24]

3) [7:136.3] **Subordination to creditors' claims:** Any balance owing to a shareholder under a repurchase agreement is subordinated to claims of corporate creditors because the claim under the repurchase agreement is based on rights as a shareholder. [See *McConnell v. Estate of Butler* (9th Cir. 1968) 402 F2d 362, 367]

(b) [7:137] **Disclosures may be required:** A corporation cannot use its power to repurchase its own shares to take advantage of its shareholders. Federal and state securities laws require the corporation to disclose to the selling shareholder all material facts related to its business and to the particular transaction. [SEA § 10(b) (15 USC § 77j(b)); SEC Rule 10b-5 (17 CFR § 240.10b-5), ¶ 6:360 ff.; and Corps.C. § 25401, ¶ 6:382 ff.]

(c) [7:138] **Reporting requirements:** Corporations required to file reports under the Securities Exchange Act of 1934 must report purchases of their own shares, and are subject to additional regulations regarding such purchases. [See SEA § 13(e) (15 USC § 78m(e))]

1) [7:138.1] **Private action for violations?** Courts are split on whether an implied private right of action exists under SEA § 13(e) and SEC Rule 13e-3 in "going private" corporate repurchase transactions. [See *Howing Co. v. Nationwide Corp.* (6th Cir. 1987) 826 F2d 1470, 1474 (private right of action exists); *Dowling v. Narragansett Capital Corp.* (D RI 1990) 735 F.Supp. 1105, 1114-1116 (same); compare *Kalmanovitz v. G. Heileman Brewing Co., Inc.* (D DE 1984) 595 F.Supp. 1385, 1393-1395 (no private right of action for money damages under SEA § 13(e)); *Berg v. First American Bankshares, Inc.* (D DC 1985) 1985 WL 2232, *8 (same)]

[7:138.2 - 7:138.5] ***Reserved.***

(d) [7:138.6] **Enforceability of negotiable instrument given in payment of shares:** A negotiable instrument issued by a corporation in payment of a share redemption or repurchase is enforceable by a holder in due course who acquired the instrument without notice that it was issued for that purpose. [Corps.C. § 511]

c. [7:139] **Status of repurchased or redeemed shares:** Shares acquired either by redemption or repurchase are no longer outstanding. They are restored to the status of authorized but unissued shares, and therefore *may be reissued* by the corporation (unless the articles prohibit reissuance). [Corps.C. § 510(a)]

(Under former law, redeemed shares were restored to the status of authorized but unissued shares, but repurchased shares were held as "treasury" stock—still issued and outstanding. The modern Code, however, abolished the concept of "treasury" shares.)

(1) [7:140] **Where articles absolutely prohibit reissuance:** In the rare case where the articles absolutely prohibit the reissuance of shares, the result is different: A corporation's redemption or repurchase of its own shares *reduces* the corporation's *authorized* capital. The articles must be amended to reflect the reduction:

• [7:140.1] If *all* of the authorized shares of a *class* are reacquired, the class is *automatically eliminated* and the articles must be amended to eliminate any statement of rights, preferences, privileges and restrictions relating solely to that class. [Corps.C. § 510(b)(1)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• [7:140.2] If *all* of the authorized shares of a *series* are reacquired, the authorized number of shares of the *class* to which such shares belonged is *reduced* accordingly, and the articles must be amended to reflect the elimination of such series and reduction in the number of authorized shares of the class to which they belonged. [Corps.C. § 510(b)(1)]

• [7:140.3] If *less than all* of the authorized shares but *all of the outstanding* shares of a class or series are reacquired, the authorized number of shares of the class or series is automatically *reduced* by the number of reacquired shares, and the board must determine whether to *eliminate* the class or series or *reduce* the authorized shares by the number of reacquired shares. The articles must then be amended to reflect the elimination or reduction, as the case may be. [Corps.C. § 510(b)(2)]

• [7:140.4] If *less than all* of the *outstanding* shares of a class or series are reacquired, the authorized number of shares of that class or series is *automatically reduced* by the number of reacquired shares, and the articles must be amended to reflect that reduction. [Corps.C. § 510(b)(3)]

(2) [7:140.5] **Where articles prohibit only reissuance *as shares of same series:*** In the even rarer case where the articles prohibit only reissuance of those shares as shares *of the same series*, the effect of a reacquisition of shares on the corporate capital structure is more complicated:

• [7:140.6] If *all* of the *authorized* shares of a series are reacquired, the series is *automatically eliminated* and the articles must be amended to eliminate any statement relating solely to such series. Further, the board must either (i) return those shares to the status of authorized but undesignated shares of the class to which they belong, or (ii) eliminate those shares entirely. In either case, the articles must be amended to reflect the reduction in authorized shares of that series and any effect on the class to which that series belonged. [Corps.C. § 510(c)(1)]

• [7:140.7] If *all* of the *outstanding* (but less than all of the *authorized*) shares of a series are reacquired, the board must determine whether to eliminate the series. Where the series is *eliminated*, the articles must be amended to delete any statement relating solely to that series. Where the series is *not* eliminated, the articles must be amended to reflect the return of the reacquired shares to the status of authorized but undesignated shares of the class to which they belong. [Corps.C. § 510(c)(2)]

• [7:140.8] If *less than all* of the *outstanding* shares of a series are reacquired, the authorized number of shares of that series is *automatically reduced* by the number of reacquired shares, and the board must either (i) return those shares to the status of authorized but undesignated shares of the class to which they belong, or (ii) eliminate those shares entirely. In either case, the articles must be amended to reflect the reduction in the authorized shares of that series and any effect on the class to which that series belongs. [Corps.C. § 510(c)(3)]

[7:140.9] ***Reserved.***

(3) [7:140.10] **Filing amendment to articles; shareholder approval *not required:*** A *certificate of amendment* to the articles of incorporation must be filed in accordance with Corps.C. § 900 (*see* ¶ *8:34*) to reflect any reduction of authorized capital and any related change to the rights, preferences, privileges and restrictions of any series or class that has been eliminated. Shareholder approval is not required for any such amendment. [Corps.C. § 510(f)]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 7-E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki ‘Vicki’ Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 7. Dividends and Other Distributions

E. Liability for Unlawful Distributions

1. [7:142] Directors' Liability
  a. [7:143] Which directors liable
  b. [7:144] Defenses to liability
    (1) [7:145] Absence or opposition at meeting
    (2) [7:146] Good faith and reasonable care
      (a) [7:147] Reliance on others as defense
      (b) [7:148] Factors showing reasonable reliance
  c. [7:149] Who may sue
    (1) [7:150] Existing creditors
      (a) [7:151] Claim need not be due
      (b) [7:152] Example
      (c) [7:153] Compare—“voidable transactions”
    (2) [7:154] Preferred shareholders
      (a) [7:155] Injury essential
  d. Extent of directors' liability
    (1) [7:156] Damages recoverable
      (a) [7:157] Interest
      (b) [7:157.1] Limitation on liability
    (2) [7:158] Right to contribution from other directors
      (a) [7:159] In same action, proceed by cross-complaint
      (b) [7:160] Contribution
    (3) [7:161] Rights against receiving shareholders
2. [7:162] Liability of Receiving Shareholders
  a. [7:163] Knowledge of impropriety required
    (1) [7:164] Application
    (2) [7:165] Knowledge may be presumed
    (3) [7:167] Compare—“voidable transactions”
  b. [7:168] Defenses to liability
  c. [7:169] Who may sue
    (1) [7:170] Existing creditors
    (2) [7:171] Preferred shareholders
      (a) [7:171.1] Not subject to § 800 derivative suit requirements
        1) [7:171.2] Application to SPCs?

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

d. [7:171.6] Four-year limitations period
e. Extent of shareholder liability
(1) [7:172] Damages recoverable
(a) [7:172.1] Interest
(b) [7:172.2] Limitation on liability
(2) [7:173] Contribution from other shareholders
(a) [7:174] In same action, proceed by cross-complaint
(3) [7:175] No rights against directors

[7:141] Under the Code, both the board of directors and recipient shareholders may be held personally liable for any distribution which violates the statutory limitations discussed above (*¶ 7:10 ff.*).

1. [7:142] **Directors' Liability:** Subject to the possible defenses noted below (¶ 7:144 ff.), directors who approve a distribution to shareholders violating §§ 500-501 are jointly and severally liable *to the corporation* for the amount of such distribution. [Corps.C. § 316(a)(1); see also Corps.C. § 2701(a) (SPCs, ¶ *9:84*]

a. [7:143] **Which directors liable:** All directors who vote for the unlawful distribution are liable. So also are any directors who were present at the meeting and *failed to vote against it*—i.e., a director who abstains is considered to have approved the action. [Corps.C. § 316(b); see also Corps.C. § 2701(b) (SPCs)]

b. [7:144] **Defenses to liability:** The Code recognizes a number of defenses that may be asserted by directors sued for unlawful distributions:

(1) [7:145] **Absence or opposition at meeting:** First of all, of course, directors can avoid personal liability by proving they were absent at the meeting where the unlawful distribution was authorized; or that they actually voted against it. [See Corps.C. § 316(b), ¶ 7:143; see also Corps.C. § 2701(b) (SPCs)]

(2) [7:146] **Good faith and reasonable care:** The directors' liability is *not* absolute. They can avoid liability by proving they acted in "good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders, and with such care, including reasonable inquiry, as an *ordinarily prudent person* in a like position would use under similar circumstances." [Corps.C. §§ 309(a), (c), 316(a) (emphasis added); see also Corps.C. § 2700(a), (d) (SPCs)]

(a) [7:147] **Reliance on others as defense:** Directors frequently have to rely on information presented to them by others in approving shareholder distributions. Often, they have no personal knowledge of the corporation's finances, and rely on financial statements prepared by corporate officers or accountants. Such reliance is a defense to liability for unlawful distributions (and various other matters subjecting directors to liability) so long as in "*good faith*" and "*reasonable*" under the circumstances. [See *England v. Christensen* (1966) 243 CA2d 413, 431, 52 CR 402, 415]

(b) [7:148] **Factors showing reasonable reliance:** The Code enumerates particular factors which, if proved, establish the "reasonableness" of the directors' reliance on reports obtained from others. Specifically, directors may avoid personal liability by proving that:

- They relied on information or reports from persons *believed to be competent* as to the matters presented (e.g., other directors, a board committee upon which the director does not serve, or corporate officers or employees; or "outside" experts, such as lawyers, accountants, etc., as to matters within their knowledge or expertise); and

- They had *no knowledge* of any fact that would cause their reliance on such information or reports to be unwarranted; and

- They made *reasonable inquiry* as to any matters where the need for such inquiry was indicated by the circumstances. [Corps.C. § 309(b); see also Corps.C. § 2700(b) (SPCs, ¶ *9:83*)]

c. [7:149] **Who may sue:** The directors' liability is owed *to the corporation* for the benefit of its existing creditors and any preferred shareholders whose rights are affected by the unlawful distribution. [Corps.C. § 316(a); see also Corps.C. § 2701(a) (SPCs)]

Such creditors or shareholders may file suit *in the name of the corporation* against the directors liable for the unlawful distribution. [Corps.C. § 316(c); see also Corps.C. § 2701(c) (SPCs)]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [7:150] **Existing creditors:** Only creditors whose debts or claims arose *before* the unlawful distribution, and who have not consented thereto, may file such suit. Subsequent creditors cannot recover. [See *UMF Systems, Inc. v. Eltra Corp.* (1976) 17 C3d 753, 757, 132 CR 129, 131]

(a) [7:151] **Claim need not be due:** If the debt *exists* at the time of the unlawful distribution, the creditor is entitled to recover. The claim may be unmatured, or even contingent. Rationale: Holders of unmatured claims are as apt to be damaged by the unlawful distribution as holders of matured claims. [*UMF Systems, Inc. v. Eltra Corp*. (1976) 17 C3d 753, 757, 132 CR 129, 131]

(b) [7:152] **Example:** Amounts paid by corporation for repurchase of its shares rendered it unable to pay its debts as they came due. Later, it defaulted in paying the rent due under a lease that had been in existence when the shares were repurchased. Although the default occurred *after* the unlawful distribution, the directors were personally liable, because the lease constituted a *preexisting obligation* of the corporation. [*UMF Systems, Inc. v. Eltra Corp*. (1976) 17 C3d 753, 757, 132 CR 129, 131]

(c) [7:153] **Compare—"voidable transactions":** If a dividend or distribution constitutes a "voidable transaction" under the Uniform Voidable Transactions Act, even *future creditors* may be able to set it aside. E.g., transfers rendering the corporation insolvent in the bankruptcy sense; or made with intent to defraud, or with knowledge that it would be unable to pay its debts. [Civ.C. § 3439 et seq.]

(2) [7:154] **Preferred shareholders:** An action in the corporate name may also be maintained by preferred shareholders who did not consent to the unlawful distribution, if it adversely affected their dividend or liquidation preferences. [Corps.C. § 316(c)]

(a) [7:155] **Injury essential:** Note that preferred shareholders can file such suit only if the unlawful distribution in fact injures them. Liability is limited to the "injury suffered by nonconsenting shareholders." [See Corps.C. § 316(d), ¶ 7:156 ff.]

d. Extent of directors' liability

(1) [7:156] **Damages recoverable:** Subject to limitation (¶ *7:157.1*), the directors are liable for the *full amount* of *money* distributed illegally. [Corps.C. § 316(d); see also Corps.C. § 2701(d) (SPCs)]

Where the distribution consists of *property*, damages are measured by the *fair market value* of the property at the time of the illegal distribution, together with any reasonably-incurred appraisal or valuation costs. [Corps.C. § 316(d); see also Corps.C. § 2701(d) (SPCs)]

(a) [7:157] **Interest:** Recoverable damages include interest, at the legal rate on judgments, accruing from the date of the illegal distribution until payment. [Corps.C. § 316(d); see also Corps.C. § 2701(d) (SPCs)]

(b) [7:157.1] **Limitation on liability:** The directors' liability for an illegal distribution may *not exceed* (i) the liabilities the corporation owed at the time of the distribution to creditors who did not consent to the distribution and (ii) the injury suffered by shareholders who did not consent to the distribution. [Corps.C. § 316(d); see also Corps.C. § 2701(d) (SPCs)]

(2) [7:158] **Right to contribution from other directors:** If less than all of the directors are sued, the ones sued can "implead" the others in the same action. [Corps.C. § 316(e); see also Corps.C. § 2701(e) (SPCs)]

(a) [7:159] **In same action, proceed by cross-complaint:** Use of the term "implead" in Corps.C. § 316(e) (and Corps.C. § 2701(e)) is actually misleading … since there is *no* "impleader" procedure under California law (as there is under federal law; see FRCP 14, and Stevenson & Fitzgerald, *Rutter Group Prac. Guide: Federal Civ. Pro. Before Trial* (TRG), Ch. 7). If seeking relief against the other directors in the *same action*, the proper procedure under California law is a *cross-complaint for indemnification*.

(b) [7:160] **Contribution:** Where a judgment has been obtained against one director, that director may compel contribution from the others, either in the same lawsuit (by cross-complaint) or by an independent action (i.e., an independent complaint). (Directors sued for contribution are entitled to assert the same defenses as if sued directly.) [Corps.C. § 316(e); see also Corps.C. § 2701(e) (SPCs)]

(3) [7:161] **Rights against receiving shareholders:** Directors held liable are also entitled to be *subrogated* to the corporation's right to recover the unlawful distributions from the shareholders who received them. (As will be seen below (¶ 7:162 ff.), such right is limited to cases in which the shareholders *knew* of the illegality of the distributions when they were received.) [Corps.C. § 316(f); see also Corps.C. § 2701(f) (SPCs)]

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

The directors' right to subrogation may be asserted by cross-complaint in the action in which they are sued, or by independent action after they are held liable.

2. [7:162] **Liability of Receiving Shareholders:** A shareholder who receives an unlawful distribution from the corporation "with *knowledge* of facts indicating the impropriety thereof" is also personally liable for the amount received. (It is immaterial whether such shareholder still owns the shares at the time suit is brought.) [Corps.C. § 506(a) (emphasis added)]

a. [7:163] **Knowledge of impropriety required:** Liability is limited to those shareholders who knew of the "impropriety" *when they received* the distribution. [Corps.C. § 506(a)]

(1) [7:164] **Application:** But it is sufficient if the receiving shareholders knew the *facts* making the distribution illegal (e.g., no earnings and negative net worth), even if they did not know of the statutes making it illegal. [See *England v. Christensen* (1966) 243 CA2d 413, 430-431, 52 CR 402, 414; *Federal Sav. & Loan Ins. Corp. v. Molinaro* (9th Cir. 1990) 901 F2d 1490, 1493]

(2) [7:165] **Knowledge may be presumed:** A recipient shareholder involved in day-to-day management of the corporation is presumed to have knowledge of all relevant facts. Likewise, *controlling shareholders* are *presumed* to have the requisite knowledge to impose such liability. [See *Gray v. Sutherland* (1954) 124 CA2d 280, 286, 268 P2d 754, 759; *Federal Sav. & Loan Ins. Corp. v. Molinaro* (9th Cir. 1990) 901 F2d 1490, 1493]

➪ [7:166] ***PRACTICE POINTER:*** In closely-held corporations, where all shareholders are active in management, it may be impossible to avoid shareholder liability for illegal distributions because *all* shareholders may be presumed to know the pertinent facts.

This raises a serious problem with "buy-out" agreements that purport to obligate the corporation to repurchase the shares of a retiring or deceased shareholder: If the agreement is performed, the withdrawing shareholder (or their estate) may be subject to liability for unlawful distributions.

To mitigate against this risk, the board should carefully consider the corporation's financial condition at the time the agreement is approved and entered into, including obtaining financial statements, certified by the corporation's chief financial officer, attesting that the statements have been prepared from the corporate books and records consistently with prior practice and establishing the corporation's solvency at the time the agreement is entered into. In addition, if practicable, consideration should be given to obtaining the consent of major creditors and preferred shareholders to the corporation entering into the buy-out agreement.

(3) [7:167] **Compare—"voidable transactions":** "Knowledge of the impropriety" is *not* required where the transfer renders the corporation insolvent in the bankruptcy sense (more liabilities than assets), or otherwise constitutes a "voidable transaction" under the Uniform Voidable Transactions Act (Civ.C. § 3439 et seq.). In such cases, the recipient shareholders are liable—whether or not they are "innocent." [Corps.C. § 506(d)]

b. [7:168] **Defenses to liability:** Technically, lack of knowledge of the impropriety is the only "defense" to shareholder liability (except that this is no defense to a "voidable transaction," *see ¶ 7:167*).

However, a shareholder may also avoid liability by proving that the corporate creditors and preferred shareholders *consented* to the distribution … because their consent bars their right to file suit (Corps.C. § 506(b), *see ¶ 7:169*).

c. [7:169] **Who may sue:** As with directors' liability (*¶ 7:142*), shareholders receiving unlawful distributions are liable *to the corporation* for the benefit of its existing creditors and any preferred shareholders whose dividend or liquidation preferences have been impaired by the distribution and *who did not consent* thereto. Such creditors or preferred shareholders are entitled to *sue in the name of the corporation* to enforce such liability. [Corps.C. § 506(b)]

(1) [7:170] **Existing creditors:** Suit may be brought by any one or more of its existing creditors—those whose claims arose *before* the shareholder received the distribution. Their claims do not have to be liquidated or reduced to judgment. [Corps.C. § 506(b)]

(2) [7:171] **Preferred shareholders:** An action in the corporate name may also be brought by any one or more preferred shareholders, if it adversely affected their dividend or liquidation preferences. [Corps.C. § 506(b)]

(a) [7:171.1] **Not subject to § 800 derivative suit requirements:** Such an action by preferred shareholders is *not* subject to the Corps.C. § 800 procedural requirements otherwise applicable to a shareholder derivative suit. [See Corps.C. § 506(b); *and ¶ 6:602 ff.*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) [7:171.2] **Application to SPCs?** The Corps.C. § 506(b) "exemption" from the derivative suit requirements refers specifically to Corps.C. § 800. Derivative suits brought on behalf of an SPC are governed not by Corps.C. § 800 but, rather, by Corps.C. § 2900 (*see ¶ 9:161 ff.*). The failure to include a reference to Corps.C. § 2900 in Corps.C. § 506(b) is probably a legislative oversight.

[7:171.3 - 7:171.5] ***Reserved.***

d. [7:171.6] **Four-year limitations period:** An action against a shareholder to recover an illegal distribution must be brought within four years after the date the distribution is made. [Corps.C. § 506(b), last sent.]

e. Extent of shareholder liability

(1) [7:172] **Damages recoverable:** Subject to limitation (¶ *7:172.2*), a shareholder receiving an illegal distribution is liable for the *full amount* of *money received* by the shareholder. [Corps.C. § 506(a)]

Where the shareholder receives a distribution of *property*, damages are measured by the *fair market value* of the property at the time of the illegal distribution, together with any reasonably-incurred appraisal or valuation costs. [Corps.C. § 506(a)]

(a) [7:172.1] **Interest:** Recoverable damages include interest, at the legal rate on judgments, accruing from the date of the illegal distribution until payment. [Corps.C. § 506(a)]

(b) [7:172.2] **Limitation on liability:** A shareholder's liability for an illegal distribution, like the directors' liability (¶ *7:157.1*), may not exceed (i) the liabilities the corporation owed at the time of the distribution to creditors who did not consent to the distribution and (ii) the injury suffered by shareholders who did not consent to the distribution. [Corps.C. § 506(a)]

(2) [7:173] **Contribution from other shareholders:** A shareholder sued for receipt of unlawful distributions may "implead" in the same lawsuit all other shareholders who may be liable (i.e., those with "knowledge" of the impropriety). Or, they may compel contribution against such other shareholders in an independent lawsuit. [Corps.C. § 506(c)]

(a) [7:174] **In same action, proceed by cross-complaint:** Again, since there is no "impleader" under California law, a defendant shareholder seeking relief against other shareholders in the same action should proceed by *cross-complaint for indemnification* (*see* ¶ *7:159*).

(3) [7:175] **No rights against directors:** The directors approving the unlawful distribution have subrogation rights against the recipient shareholders if they knew of the impropriety (*see* ¶ *7:161*). But the converse is not true: The shareholders do *not* have any right of recovery against the directors.

• [7:176] **Comment:** The result is that the ultimate loss will be borne by the shareholders *if they knew* of the impropriety. If not, the loss will be borne by the directors.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 7-F

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 7. Dividends and Other Distributions

F. Tax Consequences of Distributions

- 1. [7:178] Dividends
  - a. [7:179] What constitutes "dividend"
    - (1) [7:180] Cash or property
    - (2) [7:181] Payments charged to capital
    - (3) [7:182] Corporation operating at a loss
      - (a) [7:183] Comment
  - b. [7:184] What constitutes "earnings and profits"
    - (1) [7:185] Adjustments
      - (a) [7:186] Tax-exempt income
      - (b) [7:187] Accelerated depreciation
      - (c) [7:188] Disguised dividends
    - (2) [7:189] Computations required for current and past years
  - c. [7:191] Disguised ("constructive") dividends
    - (1) [7:198] Payments to certain shareholders only
    - (2) [7:199] Compare—stock dividends
  - d. [7:200] Amount taxable as "dividend"
    - (1) [7:201] Limited to "earnings and profits"
      - (a) [7:201.1] Effect of distribution exceeding "earnings and profits"
      - (b) [7:201.2] Example
    - (2) [7:202] Shareholder basis in property received as dividend
      - (a) [7:203] Example
    - (3) [7:209] Dividends-received exclusions for corporate shareholders
      - (a) [7:209.1] Limitation
      - (b) [7:210] 100% exclusion on consolidated returns
  - e. [7:216] Effect on distributing corporation
    - (1) [7:217] Reduces earnings and profits
      - (a) [7:218] Amount of reduction
      - (b) [7:219] Compare—earnings and profits increased for liabilities
      - (c) [7:220] Compare—distributions of appreciated property
    - (2) [7:222] Recognition of gain or loss
    - (3) [7:227] Exception to nondeductibility rule—dividends paid to employee stock ownership plan
- 2. [7:228] Redemption or Repurchase of Shares (Non-Liquidation)
  - a. [7:228.1] Tax consequences to corporation—redemption payments not deductible

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [7:228.1a] Repurchase by "related person"
(2) [7:228.2] Compare—interest on repurchase-related debt
b. [7:229] Redemptions taxable as dividends
(1) [7:229.1] Taxable gain to redeeming corporation
c. [7:230] Redemptions taxable as "sale or exchange" of shares
(1) [7:231] Complete termination of shareholder's interest
(a) [7:231.1] "Step transactions" permissible
1) [7:231.2] Sale coupled with redemption
(b) [7:231.3] May retain interest as creditor
1) [7:231.4] Dividend treatment where interest contingent on earnings
2) [7:231.5] Interest may not be proprietary
(c) [7:231.6] May not retain interest as employee or independent contractor
(d) [7:232] Attribution rules apply
1) [7:233] Waiver of attribution rules
(2) [7:234] "Substantially disproportionate" redemptions
(a) [7:235] Test
(b) [7:236] Attribution rules
(3) [7:237] "Not essentially equivalent to a dividend"
(a) [7:238] What constitutes "meaningful" reduction
1) [7:239] Effect on proportionate ownership
2) [7:241] Effect on voting power
(b) [7:242] Attribution rules
(4) [7:243] Redemptions to pay death taxes
(5) [7:243.1] "Greenmail" redemptions
d. [7:244] Compare—distributions in liquidation
(1) [7:244.1] Partial liquidation
(2) [7:244.2] Complete liquidation
e. [7:244.3] Compare—tax consequences to remaining shareholders
(1) [7:244.4] Exception where redemption relieved remaining shareholders from purchase obligation

[7:177] With limited exceptions (*¶ 7:227*), distributions to shareholders are not deductible and thus have no tax advantage to the corporation. [IRC § 311; see *Boise Cascade Corp. v. United States* (9th Cir. 2003) 329 F3d 751, 754]

The tax consequences to the receiving shareholders depends on whether the distribution is (a) *cash vs. property,* and (b) a *dividend vs. repurchase* of shares.

1. [7:178] **Dividends:** As stated above (¶ 7:177.1), "dividends" received by *individual* shareholders are taxed at the same rate as capital gains—i.e., 0% to 20%, depending on the individual's tax bracket. (There is also a 3.8% surtax on dividends received by individuals earning more than $200,000 per year and couples earning more than $250,000 per year.) [IRC §§ 1(h)(1)(C), 61(a)(7), 301(c), 1411(a)(1),(b),(c); *see ¶ 2:100 ff.*]

(A portion of the dividends received by *corporate* shareholders is excluded from income and the remainder is treated as ordinary income; *see ¶ 7:209*.)

a. [7:179] **What constitutes "dividend":** *Any* distribution to the shareholders (no matter what it is called) is treated as a "dividend" to the extent the corporation has current or accumulated *earnings and profits*. [IRC § 316(a); see generally, *Boulware v. United States* (2008) 552 US 421, 424-425, 128 S.Ct. 1168, 1173-1174]

(1) [7:180] **Cash or property:** The form of the payment is immaterial; it may be in cash, property or other stock or securities. [IRC § 317(a)]

Exception: Shares of the distributing corporation, or the right to acquire such shares, are not simply "dividends." Rather, they are treated separately as "*stock dividends*" (*see ¶ 7:283*).

(2) [7:181] **Payments charged to capital:** The corporation cannot avoid a distribution being taxed as a "dividend" by charging it to capital or some other account—i.e., a shareholder distribution is conclusively presumed to be paid "out of"

earnings and profits to the extent they exist. [IRC § 316(a): "[E]very distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits"]

(3) [7:182] **Corporation operating at a loss:** A distribution to shareholders may be taxable as a dividend even if the corporation itself is currently operating at a loss. It is sufficient that the distribution is made out of *accumulated* earnings and profits. [IRC § 316(a)]

(a) [7:183] **Comment:** Thus, it makes no difference that the profits were earned before the shareholder purchased the shares. Dividends paid out of profits made in earlier years are taxable income to later shareholders, even though the corporation has been losing money and the shares have gone down in value since they invested.

b. [7:184] **What constitutes "earnings and profits":** "Earnings and profits" are computed by starting with the corporation's taxable income, and subtracting income tax paid and any previous dividends distributed. [See generally, *Boulware v. United States* (2008) 552 US 421, 425, 128 S.Ct. 1168, 1173, fn. 3]

(1) [7:185] **Adjustments:** The remaining balance is then adjusted to reflect special tax consequences of particular items, including:

(a) [7:186] **Tax-exempt income:** Earnings and profits are *increased* by items which are not taxable income to the corporation; e.g., interest on municipal bonds. [Treas.Reg. § 1.312-6]

(b) [7:187] **Accelerated depreciation:** Earnings and profits are also increased by any depreciation claimed by the corporation over the straight-line rates. Moreover, there are special rules which "stretch out" the life of certain property for depreciation purposes. [See IRC § 312(k)]

(c) [7:188] **Disguised dividends:** On the other hand, earnings and profits are *reduced* by the amount of excessive salaries, etc., paid to shareholder-employees (¶ 7:191 ff.). (Disguised dividends reduce earnings and profits as well as formally-declared dividends.)

(2) [7:189] **Computations required for current and past years:** It is necessary to compute "earnings and profits" both for the current year and for *all previous years*, because a "dividend" may be paid either out of current or *accumulated* earnings and profits. If *either* computation results in a positive balance, the distribution is taxable as a dividend.

➪ [7:190] ***PRACTICE POINTER:*** The computation of "earnings and profits" to determine taxability of dividends can be an extremely complex analysis. Ordinarily, neither management nor counsel should undertake such analysis without the assistance of competent accounting and tax experts.

c. [7:191] **Disguised ("constructive") dividends:** For tax purposes, dividend classification is not dependent upon formal authorization and declaration by the board of directors. Whenever a corporation confers economic benefits on some or all of its shareholders *without an adequate quid pro quo*, the payment may be challenged by the IRS as a "constructive dividend" to such shareholders. [See generally, *Boulware v. United States* (2008) 552 US 421, 429-436, 128 S.Ct. 1168, 1176-1180]

Typical examples:

• [7:192] **Excessive salaries** or other forms of compensation or benefits (including retirement fund contributions) paid to shareholder employees or their *relatives*. [See *Metro Leasing & Develop. Corp. v. Commr.* (9th Cir. 2004) 376 F3d 1015, 1017-1019; *DKD Enterprises v. Commr*. (8th Cir. 2012) 685 F3d 730, 734-736 (*discussed at ¶ 2:106*); *Eberl's Claim Service, Inc. v. Commr.* (10th Cir. 2001) 249 F3d 994, 998-1002; also see *O.S.C. & Assocs., Inc. v. Commr.* (9th Cir. 1999) 187 F3d 1116, 1119-1121 (*discussed at ¶ 2:107.1*); *and ¶ 6:416 ff.*]

• [7:193] **Excessive prices** paid to a shareholder for the purchase or lease of shareholder property. [See *Goldstein v. Commr*. (9th Cir. 1962) 298 F2d 562, 566-568; Treas.Reg. § 1.301-1(j)]

• [7:194] **"Bargain" sales** of corporate property or services to a shareholder; or "bargain" uses of corporate property (e.g., use of corporate car) without adequate consideration and for nonbusiness purposes. [See Rev.Rul. 58-1, 1958-1 CB 173; *Honigman v. Commr.* (6th Cir. 1972) 466 F2d 69, 73; compare *Welle v. Commr.* (2013) 140 TC 420, 425-426—no constructive dividend where corporation furnished construction services to sole shareholder at cost without charging standard profit margin]

• [7:195] **Loans** made to shareholders without the intention that they be repaid. [See *Atlanta Biltmore Hotel Corp. v. Commr.* (5th Cir. 1965) 349 F2d 677, 680; *Tahamtan v. Commr.*, TC Memo 1995-226—unrepaid loans from corporation to sole shareholder were constructive dividends where no evidence loans had fixed maturity or shareholder had any intention to repay; compare *In re Fischer* (MD TN 1994) 169 BR 43, 46-47—sole shareholder established that advances evidenced by enforceable promissory notes and partly repaid in accordance with their terms were true loans]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• [7:196] **Payment of shareholder's obligations** without receipt of adequate consideration for doing so. Or, transferring funds from one corporation to another to discharge a debt owed to or by the shareholder. [See *Walker v. Commr.* (7th Cir. 1966) 362 F2d 140, 143, aff'g *Robert R. Walker, Inc. v. Commr.*, TC Memo 1965-28; *Wall v. United States* (4th Cir. 1947) 164 F2d 462, 464—corporation purchased its own shares to satisfy shareholder's contractual obligation to do so; and *Mills v. I.R.S.* (4th Cir. 1988) 840 F2d 229, 235]

• [7:197] **Non-bona fide shareholder debt** (payments of principal or interest on loans made by shareholders to the corporation that have been reclassified as "equity"). [IRC § 385; *see* *¶ 3:41*]

(1) [7:198] **Payments to certain shareholders only:** Payments may be found to be "constructive dividends" although paid only to some shareholders and not to others—i.e., the fact that such payments violate state statutes requiring that dividends be paid pro rata (*¶ 7:9*) does not prevent a finding that they are "dividends" for tax purposes.

(2) [7:199] **Compare—stock dividends:** A corporation's distribution of its own stock (or rights to acquire same) is ordinarily *not* taxable as a "dividend" to its shareholders. But even a stock dividend may be treated as a cash or property distribution under certain circumstances (*see* *¶ 7:287*).

d. [7:200] **Amount taxable as "dividend":** The amount of the "dividend" for tax purposes is:

• The amount of cash distributed; plus

• The fair market value of any property distributed, less the amount of any liabilities assumed or to which the property is subject. [IRC § 301(b)(1), (2)]

(1) [7:201] **Limited to "earnings and profits":** Amounts taxable as a "dividend" cannot exceed the distributing corporation's current and accumulated "earnings and profits" (*¶ 7:184*). Thus, where there are no current or accumulated earnings and profits, there is no "dividend." [See generally, *Boulware v. United States* (2008) 552 US 421, 432-433, 128 S.Ct. 1168, 1178]

(a) [7:201.1] **Effect of distribution exceeding "earnings and profits":** A corporate distribution exceeding the corporation's (current or accumulated) "earnings and profits" is treated as a *return of capital*, reducing the shareholder's basis on their stock. After the basis is reduced to zero, any remaining amount would be taxed as capital gain. [IRC § 301(c)(2), (3)]

(b) [7:201.2] **Example:** XYZ Corp. has accumulated earnings and profits of $100,000 and current earnings of $50,000. It distributes $400,000 to its sole shareholder, S. Of this amount, $150,000 is taxable as a dividend. If the tax basis on S's stock was $100,000, the next $100,000 of the distribution would be tax-free as a return of capital; the balance ($150,000) would be taxed as a capital gain.

(2) [7:202] **Shareholder basis in property received as dividend:** Shareholders get a "stepped up" basis in property distributed as a dividend—i.e., the tax basis of such property in the receiving shareholder's hands is its fair market value at the time of distribution (without reduction for liabilities). [IRC § 301(d)]

(a) [7:203] **Example:** Property worth $50,000, but subject to a lien of $30,000, is distributed to shareholder, S. The amount of the dividend is $20,000. The basis of the property in S's hands, however, is $50,000.

[7:204 - 7:208] *Reserved.*

(3) [7:209] **Dividends-received exclusions for corporate shareholders:** Dividends received by a corporation from another domestic corporation are taxed as *ordinary income*. However, the shareholder corporation is entitled to *deduct 50%* of the amount received—i.e., only 50% of the dividend is taxable. [IRC § 243(a)(1)]

Further, if the receiving corporation *owns 20% or more* (but less than 80%) in voting power and value of the dividend-paying corporation's stock, it is entitled to a *65%* deduction—i.e., only the balance of 35% of the dividend is taxable. [IRC § 243(c)]

(a) [7:209.1] **Limitation:** A corporation will not receive the full applicable dividends-received deduction where it has incurred an interest expense (by borrowing or issuing its own debt securities) in order to purchase the other corporation's stock. That is, it cannot deduct the interest expense and escape taxation on the dividends at the same time. In such cases, the dividends-received deduction is reduced to the extent the stock was bought on borrowed funds; but the reduction is limited to the amount of interest paid on the financing. [See IRC § 246A]

(b) [7:210] **100% exclusion on consolidated returns:** Moreover, if the two corporations are "affiliated" (part of a chain of corporations in which the parent owns at least 80% in value and voting power of the stock of each subsidiary), 100% of the dividends may be excluded. If the affiliated group files a *consolidated return*, intercorporate dividends among members of the group are eliminated. (Since their returns are consolidated, shifting of profits between the corporations has no impact on the bottom line taxes payable.) [IRC §§ 243(b), 1504(a)]

[7:211 - 7:215] ***Reserved.***

e. [7:216] **Effect on distributing corporation:** As stated earlier (*¶ 7:177*), a dividend distribution generally is not deductible by the corporation. But such distribution may have other important tax consequences to the distributing corporation:

(1) [7:217] **Reduces earnings and profits:** First of all, a dividend distribution serves to reduce the corporation's earnings and any penalty taxes on unreasonable accumulations of earnings. [IRC § 312(a); *see ¶ 2:113*]

(a) [7:218] **Amount of reduction:** Generally, earnings and profits are reduced by the amount of cash and the adjusted basis of any property distributed; and, where corporate notes or other evidences of indebtedness are distributed, by the principal amount thereof. [IRC § 312(a)]

(The amount of reduction is *not* affected by whether the distributee is entitled to exclude all or a portion of the dividend under the "dividend received" deduction; *¶ 7:209 ff.*)

(b) [7:219] **Compare—earnings and profits increased for liabilities:** The amount of the reduction is adjusted for the amount of any liability to which the property distributed is subject, or assumed by the shareholders to whom it is distributed. [IRC § 312(c)]

(c) [7:220] **Compare—distributions of appreciated property:** If the corporation distributes property having a fair market value in excess of adjusted basis, earnings and profits are *increased* by the amount of the excess and *decreased* by the property's fair market value. [IRC § 312(b)]

[7:221] ***Reserved.***

(2) [7:222] **Recognition of gain or loss:** Ordinarily, the distributing corporation recognizes neither gain nor loss on a distribution to its shareholders that is not in partial or complete liquidation, whether in stock, cash or property. [IRC § 311(a)]

But there are a number of important exceptions to this general rule:

• [7:223] *Gain* (but not loss) will be recognized where *appreciated property* is distributed as a dividend or to redeem stock. The tax effect is the same as if the corporation sold the property to the shareholders at its fair market value. [IRC § 311(b); see *Pope & Talbot, Inc. v. Commr*. (9th Cir. 1999) 162 F3d 1236, 1239; see also *Bross Trucking, Inc. v. Commr*., TC Memo 2014-107—"appreciated goodwill" was developed and owned by sole shareholder and hence was not distributed by corporation to him]

• [7:224] Gain may be recognized where the property is distributed subject to *liabilities exceeding* its adjusted basis to the distributing corporation. In such cases, the fair market value of the distributed property is deemed to be at least the amount of the liabilities. [IRC §§ 311(b)(2), 336(b)]

Where multiple assets are distributed, the *liabilities* assumed by the recipient shareholder will be allocated to the particular assets that *secure* them (if any). Any *unsecured* liabilities will be allocated among the distributed assets according to the assets' respective fair market values (i.e., the corporation cannot "aggregate" the distributions). [IRC § 311(b)(2); see *H & M Auto Elec., Inc. v. Commr*. (1989) 92 TC 1269, 1273-1275]

• [7:225] Gain may be recognized on distribution of certain depreciable property to which the depreciation recapture rules (IRC §§ 1245, 1250) apply.

[7:226] ***Reserved.***

(3) [7:227] **Exception to nondeductibility rule—dividends paid to employee stock ownership plan:** A corporation may deduct a dividend paid to an employee stock ownership plan if the dividend is:

• Paid in cash to plan participants or their beneficiaries; *or*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- Paid to the plan and distributed in cash to participants or their beneficiaries not later than 90 days after the close of the plan year in which paid; *or*
- Paid to the plan and, at the participant's election, reinvested in plan securities; *or*
- Used to make payments on a loan taken out to acquire stock held by the plan. [IRC § 404(k)(1), (2)(A); see *Boise Cascade Corp. v. United States* (9th Cir. 2003) 329 F3d 751, 754-756—payments to employee stock ownership plan made by corporation to redeem stock of terminated employees (participants) were deductible dividends]

2. [7:228] **Redemption or Repurchase of Shares (Non-Liquidation):** Any purchase by a corporation of its own shares (for cash or property) is treated as a "redemption" for tax purposes. [IRC § 302]

Certain redemptions are treated as *dividends* to the shareholders and hence taxable in whole to the individual recipients. Others are treated as a "*sale or exchange*" and thus represent a return of capital to the extent of the shareholders' basis in their stock, with any remainder taxable as capital gains.

a. [7:228.1] **Tax consequences to corporation—redemption payments not deductible:** Amounts paid by a corporation in connection with a redemption of its stock (including legal and accounting fees) must be *capitalized* and are *not deductible* by the corporation. [IRC § 162(k)(1)] This includes the purchase price of the reacquired shares, even where the repurchase is to protect against a takeover (i.e., "greenmail" payments; *¶ 7:134*). [See *United States v. Houston Pipeline Co.* (5th Cir. 1994) 37 F3d 224, 228-230]

The IRA imposed a 1% excise tax on stock repurchases by certain covered corporations (generally, corporations traded on an exchange). Tax-free spin-offs and split-offs are excluded from the base of the excise tax, with some exceptions. Redemptions of preferred stock are generally subject to the excise tax. [26 USC § 4501(a); IRS Notice 2023-2]

(1) [7:228.1a] **Repurchase by "related person":** Likewise, a corporation may take no deduction for amounts it pays in connection with the reacquisition of corporate stock by a "related person." [IRC § 162(k)(1)] A "related person" includes any entity under common control with the corporation and any person owning 10% or more of the corporation's stock. [IRC §§ 267(b), 465(b)(3)(C)]

(2) [7:228.2] **Compare—interest on repurchase-related debt:** A corporation that incurs debt to finance a repurchase of its shares may deduct interest and related expenses (bank fees, investment advisor fees, brokerage commissions, etc.) paid in connection with the debt. [IRC § 162(k)(2); *In re Kroy (Europe), Ltd.* (9th Cir. 1994) 27 F3d 367, 369]

b. [7:229] **Redemptions taxable as dividends:** Wherever the economic effect of the redemption or repurchase is essentially equivalent to a dividend, it is taxable as such. (For example, a *pro rata* redemption of a portion of the shares held by each shareholder has the same economic effect as distribution of a cash dividend, since each shareholder is left with the same ownership interest; *see ¶ 7:237*.)

Such redemptions are treated as dividends to the extent of the corporation's current or accumulated earnings and profits. No portion of the distribution is treated as a return of capital until earnings and profits are exhausted.

(1) [7:229.1] **Taxable gain to redeeming corporation:** Broadly, where *appreciated property* is distributed to redeem outstanding shares, it will result in taxable gain—just as if it had been sold to the distributee at its fair market value. [IRC § 311(b); *¶ 7:223*]

c. [7:230] **Redemptions taxable as "sale or exchange" of shares:** However, the Code provides a number of "safe harbors" to avoid dividend treatment. If the redemption qualifies under one or more of the following tests, it is treated as a capital transaction: i.e., the shareholder first recovers his or her basis in the shares tax-free, with any excess taxable as a capital gain. [IRC § 302(a)]

(1) [7:231] **Complete termination of shareholder's interest:** A complete redemption of *all* shares owned by a shareholder qualifies as a capital transaction (sale or exchange). [IRC § 302(b)(3)]

(a) [7:231.1] **"Step transactions" permissible:** As long as it results in a complete termination of the shareholder's interest in the corporation, the redemption may be effected either in a single transaction or in a series of "steps" pursuant to an *integrated plan*. [See *Roebling v. Commr.* (1981) 77 TC 30, 52-55]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) [7:231.2] **Sale coupled with redemption:** For example, if a shareholder sells *some* shares, and the corporation then redeems the balance, both the sale and redemption qualify for capital gains treatment, because the seller's interest is completely terminated.

The same result follows where the redemption *precedes* the sale, if it was part of an integrated transaction—i.e., as long as the redemption was a "step" in effecting a "complete termination," the order in which the termination occurs is not critical. [See *Zenz v. Quinlivan* (6th Cir. 1954) 213 F2d 914, 917; and Rev.Rul. 55-745, 1955-2 CB 223]

(b) [7:231.3] **May retain interest as creditor:** The selling shareholder may retain an interest as a creditor without disqualifying the stock redemption from capital gain treatment. For example, they may:

— receive or retain bonds, notes or other evidence of indebtedness;

— obtain a security interest in corporate property to secure payment of the redemption amount;

— own real property leased to the corporation under a bona fide lease; or

— retain other claims against the corporation. [Rev.Rul. 70-639, 1970-2 CB 74 (landlord); see *Hurst v. Commr.* (2005) 124 TC 16, 23-25]

1) [7:231.4] **Dividend treatment where interest contingent on earnings:** If repayment of the "debt" or "claim" is contingent on the corporation's future earnings, it will be treated as a retained *equity* interest, and thus *not* a "complete termination." [Treas.Reg. § 1.302-4(d)]

2) [7:231.5] **Interest may not be proprietary:** Nor may the selling shareholder retain rights greater than those necessary to enforce claims against the corporation. For example, if the shareholder retains voting rights, or rights to veto corporate actions, until the "debt" is repaid, it may be treated as a retained equity interest, and thus *not* a "complete termination." Any rights retained must *not* be subordinate to the claims of general creditors or in any sense be "proprietary." [Treas.Reg. § 1.302-4(d)]

(c) [7:231.6] **May not retain interest as employee or independent contractor:** After the stock is redeemed, the selling shareholder may *not* continue to render services to the corporation, whether as an employee or independent contractor. This is so even if only token compensation is received. [*Lynch v. Commr.* (9th Cir. 1986) 801 F2d 1176, 1179-1182—sale did not qualify as capital transaction where selling shareholder continued to work for nominal compensation as consultant to family-owned business; compare *Hurst v. Commr*. (2005) 124 TC 16, 26-27—corporation's continued employment of selling shareholder's wife (who owned no stock) did not disqualify redemption from capital gain treatment]

➪ [7:231.7] ***PRACTICE POINTER:*** In view of the decision in *Lynch v. Commr.* (9th Cir. 1986) 801 F2d 1176, supra, prudence dictates that a shareholder seeking to qualify a stock redemption as a "complete" redemption retain *no* interest in the corporation, including any interest as an officer, director or employee. (But a retained interest as a *creditor* is permissible.) [See IRC § 302(c)(2)(A)(i)]

(d) [7:232] **Attribution rules apply:** Whether a shareholder's interest has been completely terminated must be determined in light of the "attribution rules" of IRC § 318. Under these rules, shares owned by *family members* or *related business entities* may be "attributed" to the shareholder whose shares are purchased by the corporation; i.e., they are treated as the "constructive owner" of shares actually owned by other persons or entities. [IRC § 318(a)]

• [7:232.1] **Family attribution:** Stock owned by the taxpayer's spouse, children, grandchildren and parents is treated as owned by the taxpayer. [IRC § 318(a)(1)]

(Comment: As a result, in closely-held family corporations, it is often impossible to arrange a complete termination, because stock of other family members will always be "attributed" to the shareholder whose shares are redeemed.)

• [7:232.2] **Related entities attribution:** Shares held by an entity (e.g., partnership, estate, trust or corporation) are attributed to an individual who has a beneficial interest in the entity; or, in the case of a corporation, to any individual who owns 50% or more in value of its stock. [IRC § 318(a)(2)]

Conversely, shares held by an individual are attributed *to any entity* in which they have a beneficial interest; or, in the case of a corporation, in which they own 50% or more in value of its stock.

• [7:232.3] **Options:** Persons holding options to acquire stock are treated as if they owned the stock subject to the option, for attribution purposes. [IRC § 318(a)(4)]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) [7:233] **Waiver of attribution rules:** Some relief from the family "attribution rules" is available where a family member withdraws entirely from a corporation, and has *no further interest as officer, director, employee or otherwise*; and *agrees not to reacquire any stock for 10 years*. (But this is of no help to attribution from related business entities.) [See IRC § 302(c)(2); and *Hurst v. Commr.* (2005) 124 TC 16, 22-23]

(2) [7:234] **"Substantially disproportionate" redemptions:** Even if it does not completely terminate a shareholder's interest in the corporation, a redemption will be taxed as a "sale" rather than a dividend if it is "substantially disproportionate" as to that particular shareholder (i.e., where it is clearly *not* simply a device for distributing profits pro rata while at the same time retaining the same percentage stock interests). [IRC § 302(b)(2)]

(a) [7:235] **Test:** A redemption is "substantially disproportionate" if, *after* the redemption, the shareholder owns (directly or constructively by "attribution"):

- *Less than 50%* of the *voting* power of the corporation (i.e., less than half the outstanding shares of all classes entitled to vote); *and*

- The ratio of the shareholder's remaining *voting* stock to all outstanding voting stock is *less than 80%* of what it was before the redemption; *and*

- Likewise, the ratio of the shareholder's remaining *common* stock (voting or nonvoting) is also *less than 80%* of what it was before the redemption. [IRC § 302(b)(2); and see Rev. Rul. 87-88, 1987-2 CB 81]

Cross-refer: For application of the IRC § 302 test to determine tax treatment of "boot" received in a merger, see *Commissioner of Internal Revenue v. Clark* (1989) 489 US 726, 739-740, 109 S.Ct. 1455, 1463-1464, *discussed at ¶ 8:214.1*.

(b) [7:236] **Attribution rules:** The percentages owned both before and after redemption are again determined in light of the "attribution rules" of IRC § 318 (¶ 7:232 ff.). [IRC § 302(c)(1)]

However, the provision waiving attribution rules for family members (*¶ 7:233*) does not apply. The waiver provision is limited to complete terminations, not "substantially disproportionate" redemptions.

(3) [7:237] **"Not essentially equivalent to a dividend":** Even if it fails to qualify as "complete" or "substantially disproportionate," a redemption will still be treated as a sale, rather than a dividend, if "not essentially equivalent to a dividend." [IRC § 302(b)(1)]

This is the most nebulous test and the most difficult to apply. The Supreme Court has held that it requires proof of some "*meaningful reduction*" in the shareholder's proportionate ownership interest in the corporation. [See *United States v. Davis* (1970) 397 US 301, 313, 90 S.Ct. 1041, 1048]

(a) [7:238] **What constitutes "meaningful" reduction:** There is no mathematical standard. It depends entirely on the facts and circumstances of the individual case. [Treas.Reg. § 1.302-2(b)]

1) [7:239] **Effect on proportionate ownership:** Clearly, however, there must be a significant change in the ownership *percentage* retained by the shareholder, so that the *effect* of the redemption is substantially different from the effect of a dividend distribution. [Rev.Rul. 75-502, 1975-2 CB 111; Rev. Rul. 77-426, 1977-2 CB 87, as clarified by Rev.Rul. 81-41, 1981-1 CB 121]

Thus, a pro rata (or substantially pro rata) redemption will always be taxed as a dividend. For example, if a corporation redeems one-third of its outstanding shares by *pro-rata* calls to *each* shareholder, it is "essentially equivalent to a dividend." While the number of shares outstanding is reduced, there is no change in ownership percentages; i.e., each shareholder retains the same basic ownership interest.

Likewise, if there is only a *single* stockholder (directly or by attribution), or if the shares being redeemed belong to a *discrete class* held by only a *single* stockholder, *any* redemption will be treated as a taxable dividend. [*United States v. Davis* (1970) 397 US 301, 313, 90 S.Ct. 1041, 1048; *Schroeder v. Commr.* (9th Cir. 1987) 831 F2d 856, 859; see *Boise Cascade Corp. v. United States* (9th Cir. 2003) 329 F3d 751, 754-756—redemption of terminated employees' preferred shares held by employee stock ownership plan trustee treated as dividend where trustee possessed most indicia of ownership (trustee treated as sole owner of class)]

[7:240] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2) [7:241] **Effect on voting power:** Conversely, if the shareholder had voting control before the redemption, and no longer had such control afterwards, the reduction will be "meaningful." [Rev.Rul. 76-364, 1976-2 CB 91; and see *Wright v. United States* (8th Cir. 1973) 482 F2d 600, 608-609—reduction of voting control from 85% to 61% held "meaningful" because state law required at least two-thirds vote on important corporate matters] (Caution: The IRS will not follow unless reduction is below 50%.)

(b) [7:242] **Attribution rules:** The attribution rules of IRC § 318 (*see ¶ 7:232*) apply in determining whether there has been a "meaningful" reduction of the shareholder's ownership interest in the corporation. [IRC § 302(c)(1)]

(4) [7:243] **Redemptions to pay death taxes:** Redemption of shares from a decedent's estate to pay state or federal death taxes, funeral expenses or costs of administering the estate, is taxed as a sale, rather than as a dividend … *provided* decedent's stockholdings in the corporation *exceed 35%* of the value of the estate (less deductions for expenses, claims and losses incurred by the estate). [IRC § 303(b)(2)]

(5) [7:243.1] **"Greenmail" redemptions:** Redemption of shares from a shareholder who held them less than two years and who made (or threatened) a tender offer during that period subject the shareholder to a 50% penalty tax on any "gain realized." However, this surtax does not apply if prior to the redemption the corporation offered to purchase the other shareholders' stock on the same price and terms. [IRC § 5881]

d. [7:244] **Compare—distributions in liquidation:** The foregoing rules apply to a redemption of shares by a corporation that is remaining in business. Different principles apply where shares are redeemed in partial or complete liquidation of the corporation:

(1) [7:244.1] **Partial liquidation:** Distributions to noncorporate shareholders which constitute a partial liquidation of the corporation are usually taxed as a return of capital, rather than as a dividend: i.e., they are tax-free until the shareholder's basis is recovered, and thereafter are taxed as a capital gain. [IRC § 302(b)(4)]

A distribution is considered "in partial liquidation" of the corporation where it is made pursuant to a "plan" within two years of its adoption and is "not essentially equivalent to a dividend." [IRC § 302(e)] (Typically, this refers to distributions resulting from selling off part of the corporation's business or other contraction of the enterprise, as opposed to distributions of accumulated earnings and profits; see IRC § 302(e)(2) & (3).) [See *White's Ferry, Inc. v. Commr.*, TC Memo 1993-639]

(2) [7:244.2] **Complete liquidation:** Cash or property distributed in complete liquidation of the corporation is usually taxed as a return of capital: i.e., the liquidating distribution is treated as payment for the shares, which is tax-free to the shareholders until they recover their basis on the shares; any excess is taxed at capital gains rates. [IRC § 331; see more detailed discussion in connection with dissolution at *¶ 8:1151 ff.*]

e. [7:244.3] **Compare—tax consequences to remaining shareholders:** Normally, a redemption of one shareholder's stock has no tax impact on the remaining shareholders in the corporation—i.e., they are not treated as having received any income or benefit, even if the redemption increases the value of their interests in the corporation.

(1) [7:244.4] **Exception where redemption relieved remaining shareholders from purchase obligation:** If the remaining shareholders had a primary and unconditional obligation to purchase the shares of the selling shareholder, and that obligation was satisfied by the corporation's redeeming the shares, the payments made by the corporation will be treated as a *dividend* to the remaining shareholders. [*Wall v. United States* (4th Cir. 1947) 164 F2d 462, 464-465]

But this adverse tax effect is limited to cases in which the remaining shareholders had a fixed contractual liability to purchase. It does not apply where the corporation was primarily obligated to purchase, and the remaining shareholders were only secondarily liable. [*Edenfield v. Commr.* (1952) 19 TC 13; see Rev.Rul. 69-608, 1969-2 CB 42; see also *Buchholz Mortuaries, Inc. v. Commr.*, TC Memo 1990-269]

➪ [7:244.5] ***PRACTICE POINTER:*** Be careful to structure a stock repurchase transaction so that the corporation—*not the remaining shareholders*—is primarily obligated to make the repurchase. If it is not clear initially whether the transaction will be a corporate redemption or a purchase by the remaining shareholders, be sure the documentation expressly allows the purchase obligation to be "assigned" to the corporation. [See *Buchholz Mortuaries, Inc. v. Commr.*, TC Memo 1990-269]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 7-G

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 7. Dividends and Other Distributions

G. Stock Dividends and Splits

- 1. [7:245] Stock Dividends
  - a. [7:246] Not regulated as "shareholder distribution"
  - b. [7:247] Compare—dividends in shares of other corporations
  - c. [7:248] Source of stock dividend
    - (1) [7:249] Accounting principles generally
      - (a) [7:250] Exception
    - (2) [7:251] Effect of Financial Protection and Innovation Commissioner's Rule
      - (a) [7:252] Comment
    - (3) [7:253] Effect on future "distributions"
      - (a) [7:254] Example
- 2. [7:255] Stock Splits
  - a. [7:256] Purpose
  - b. [7:257] No effect on capital or surplus
    - (1) [7:258] Example
    - (2) [7:259] Compare—stock dividend
  - c. [7:260] No restriction on source
  - d. [7:261] Articles must be amended
- 3. [7:262] Procedural Matters
  - a. [7:263] Procedures for articles amendment
- 4. [7:265] Securities Law Considerations
  - a. [7:266] Stock dividends not subject to qualification
    - (1) [7:267] No consideration for dividend shares
      - (a) [7:268] Comment
    - (2) [7:268.1] No articles amendments
    - (3) [7:269] Conditions attaching to shares issued
  - b. [7:270] Stock dividends subject to qualification requirement
    - (1) [7:271] Application
      - (a) [7:272] Stock dividend OR cash
      - (b) [7:273] Stock dividends affecting other shareholders
        - 1) [7:274] Example
    - (2) [7:276] Exemptions
      - (a) [7:277] Limited offering
      - (b) [7:277.1] Exemptions based on federal preemption

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [7:278] Mostly nonresidents affected
(d) [7:279] No adverse change
c. [7:280] Stock splits
(1) [7:282.1] Exemptions and preemption
5. [7:283] Tax Consequences
a. [7:284] Effect on shareholders' basis
(1) [7:285] Example
(2) [7:286] Effect
b. [7:287] Taxable distributions
(1) [7:288] Option given to receive cash
(2) [7:289] Disproportionate distributions
(3) [7:290] Distributions of common and preferred to same class
(4) [7:291] Dividends on preferred
(a) [7:292] Compare—stock splits
(5) [7:293] Dividends of convertible preferred shares
(6) [7:294] Other transactions
c. [7:296] Special rules as to "preferred stock bailouts" (IRC § 306)
(1) [7:297] What constitutes "Section 306 stock"
(a) [7:298] Not "common on common" dividends
(b) [7:299] Preferred shares issued in reorganization
(2) [7:300] Tax treatment of "Section 306 stock"
(a) [7:301] Upon redemption
(b) [7:302] Sale to third party
1) [7:303] Example
2) [7:304] Earnings and profits not reduced
(3) [7:305] Exceptions
(a) [7:306] Complete termination of investment
1) [7:307] Attribution rules apply
(b) [7:308] Liquidations
(c) [7:310] Nonrecognition transactions
(d) [7:311] Other legitimate purpose

1. [7:245] **Stock Dividends:** A stock dividend is a pro rata distribution of the corporation's *own shares* to existing shareholders. The effect is to increase the outstanding shares of the corporation, but without changing the percentage of ownership which each shareholder holds.

a. [7:246] **Not regulated as "shareholder distribution":** Since there is no transfer of any of the corporation's cash or other property, stock dividends do not endanger the claims of creditors or preferred shareholders. For this reason, they are not treated as "distributions to shareholders" for corporate law purposes (Corps.C. § 166), and therefore are not subject to the restrictions on cash or property distributions (Corps.C. §§ 500-501, ¶ *7:10 ff.*).

b. [7:247] **Compare—dividends in shares of other corporations:** But dividends payable in the shares of some other corporation (including *subsidiary* corporations) are "distributions" of property, and *not* a stock dividend. Their effect is to reduce the assets of the distributing corporation as much as a distribution of cash or other property. Thus, they are subject to the regulations and limitations of Corps.C. §§ 500 and 501.

c. [7:248] **Source of stock dividend:** A stock dividend increases the stated capital of the corporation by the stated value (if any) of the dividend shares issued. Where such shares have a stated value, the increase must be charged to some form of earnings or surplus account. But there is no statutory provision as to the source to be charged.

(1) [7:249] **Accounting principles generally:** Under generally accepted accounting principles applicable to *public* corporations, the "fair value" (market value, if available) of shares being issued as a stock dividend must be transferred from the corporation's "retained earnings" account and added to the category of "capital stock and additional paid-in capital." [Financial Accounting Standards Board, Accounting Standards Codification ¶ 505-20-30-3]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

The accounting transfer from "retained earnings" to "capital and additional paid-in capital" does *not*, however, affect a corporation's "earnings and profits" for tax purposes. [IRC § 312(d)(1); *see ¶ 7:184 ff.*]

(a) [7:250] **Exception:** However, under generally accepted accounting principles, a stock dividend *exceeding 25%* of the outstanding shares (i.e., a stock dividend of more than 1/4 share for each outstanding share) is treated as a "stock split" (¶ 7:255), and therefore does *not* require reduction of retained earnings. [Financial Accounting Standards Board, Accounting Standards Codification ¶ 505-20-25-5, 505-20-30-6]

(Comment: This accounting rule has only limited effect in California, because if the dividend shares have a stated value, a transfer from some surplus account is required in order to avoid qualification under the Corporate Securities Law; *see ¶ 7:251*.)

(2) [7:251] **Effect of Financial Protection and Innovation Commissioner's Rule:** The Financial Protection and Innovation (formerly Business Oversight) Commissioner's Rules define a "stock dividend" as the issuance of additional shares pro rata to existing shareholders, *without consideration* other than the transfer from some surplus account to stated capital of an amount equal to or greater than the par, stated, or market value of the distributed shares. [Commr. Rule 260.017; *see ¶ 7:267*]

(a) [7:252] **Comment:** Note that the transfer may be made from any surplus account—not necessarily retained earnings (as under the "generally accepted accounting principles," ¶ 7:249).

(3) [7:253] **Effect on future "distributions":** Reducing "retained earnings" could conceivably affect the corporation's ability to make future distributions to its shareholders. As discussed earlier, distributions to shareholders are payable only if the corporation meets the retained earnings test or the assets/liabilities test (although calculations under these tests need not be done in accordance with GAAP); see Corps.C. § 500, *¶ 7:10 ff.*

(a) [7:254] **Example:** XYZ Corp. has 100 shares of common stock outstanding with a total stated capital of $1,000, and retained earnings of $5,000. The corporation issues a 1-for-1 stock dividend (one additional share for each share outstanding). The effect is to increase shares outstanding to 200. Assuming the "fair value" of these new shares upon issuance is $25 per share, or $2,500, that amount should be transferred from the corporation's "retained earnings" account to its capital stock account (thereafter, it would have $3,500 in capital stock, $2,500 in retained earnings).

If XYZ Corp. thereafter sought to distribute $5,000 in cash to its shareholders, it would not have sufficient retained earnings if determined under GAAP. Whether such a distribution would be lawful depends on whether the board of directors could adopt a non-GAAP valuation method in good faith (*see ¶ 7:33*); or, alternatively, whether the assets/liabilities test could be met (the transfers between the surplus and capital accounts do not alter the amount of the corporation's total assets or liabilities).

2. [7:255] **Stock Splits:** A "stock split" is not a dividend. It is merely a division of shares outstanding into a greater number of shares, *through amendment of the articles* of incorporation. [Corps.C. § 188] (Conversely, a "reverse stock split" is the pro rata combination of outstanding shares into a smaller number, through amendment of the articles; Corps.C. § 182.) [See Commr. Rule 260.103.2]

a. [7:256] **Purpose:** Stock splits and reverse stock splits are encountered primarily with public corporations or privately-held corporations about to go public. The usual purpose of a stock split is to lower the value of the shares, and thus encourage more active trading in the stock. Conversely, a reverse stock split increases the per share value by reducing the number of shares outstanding, and thus may be used to "dry up" trading and facilitate "going private."

b. [7:257] **No effect on capital or surplus:** Unlike a stock dividend, a stock split does not change the corporation's capital or surplus accounts. It simply divides the shares outstanding into more shares; and the stated value of the shares previously issued is reduced accordingly.

(1) [7:258] **Example:** XYZ Corp. has 1,000 shares outstanding, a stated capital of $1,000 and earned surplus of $5,000. If XYZ declares a "2-for-1 stock split," it will issue 1,000 new shares. There will then be 2,000 shares outstanding, but the corporation's stated capital and surplus accounts do not change. Each share, formerly having a stated value of $1, now has a stated value of only fifty cents.

(2) [7:259] **Compare—stock dividend:** A 2-for-1 stock split, as above (¶ 7:258), results in the same number of additional shares outstanding as a 100% (or 1-for-1) stock dividend. But, a stock dividend *increases* the stated capital of the corporation by the stated value of the shares issued; whereas a stock split does not.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

c. [7:260] **No restriction on source:** Since there is no effect on the corporation's balance sheet, and no change in its assets or liabilities, stock splits do not endanger creditors or preferred shareholders. Therefore, there are *no* requirements that the corporation have retained earnings or surplus (i.e., a stock split may be declared even if the corporation's capital is impaired and it is operating at a loss).

d. [7:261] **Articles must be amended:** The big distinction between a stock dividend and a stock split is that the latter requires amendment of the articles of incorporation, *stating the effect on outstanding shares*. [Corps.C. §§ 182, 188]

In contrast, a stock dividend can be made without amending the articles, as long as the corporation has a sufficient number of authorized but unissued shares to declare the stock dividend (*see ¶ 7:262*).

3. [7:262] **Procedural Matters:** Both stock dividends and stock splits must be authorized and declared by resolution of the board of directors, in the same manner as the board declares a cash or property dividend (*¶ 7:76*).

A *stock dividend* must be declared out of "authorized but unissued shares." But no amendment of the articles is required unless there are insufficient shares remaining unissued to cover the dividend (in which case, an amendment increasing the number of shares authorized would be necessary).

A *stock split* or *reverse stock split*, however, *requires amendment* of the articles of incorporation to state the effect on the outstanding shares (*see ¶ 8:31*). An amendment to effect a *stock split* in a corporation having one class of outstanding stock requires only board approval. An amendment to effect a *reverse stock split*, or to effect a *stock split* in a corporation having *more than one class* of outstanding stock, must be approved by the directors *and the shareholders*. [Corps.C. §§ 182, 188, 902(c), 903(a)(2); see also Corps.C. § 3000(a)(2) (SPCs)]

a. [7:263] **Procedures for articles amendment:** *See ¶ 8:48*.

[7:264] ***Reserved.***

4. [7:265] **Securities Law Considerations:** Neither a stock dividend nor stock split is normally subject to federal securities laws, since neither involves the "offer or sale" of a security "for value" (see SA § 2(a)(3) (15 USC § 77b(a)(3))). However, some stock dividends and stock splits may require qualification under the California Corporate Securities Law:

a. [7:266] **Stock dividends not subject to qualification:** "Common on common" stock dividends are usually not subject to qualification under California law. As long as no other shares have voting rights, a stock dividend consisting *solely of common* shares (except cash for fractional shares) distributed on outstanding common stock does not change proportionate ownership or voting. Therefore, it is not a "sale" or "offer" within the coverage of the Corporate Securities Law. [Corps.C. § 25017(f)(2)]

(1) [7:267] **No consideration for dividend shares:** To avoid qualification, the stock dividend shares must be issued to existing shareholders pro rata according to shares previously held (except for cash or scrip paid for fractional shares), *without any consideration* other than the transfer of surplus to stated capital in an amount equal to or greater than the par, stated, or market value of the distributed shares. [Commr. Rule 260.017]

(a) [7:268] **Comment:** Note that the accompanying transfer can be made from *any* surplus account (not limited to earned surplus).

(2) [7:268.1] **No articles amendments:** Furthermore, the dividend may not be made by amending the articles to state the effect on outstanding shares—if it is, it will be treated as a *stock split* rather than a stock dividend. [Commr. Rule 260.017; *see ¶ 7:261*]

(3) [7:269] **Conditions attaching to shares issued:** If the existing shares are subject to conditions imposed by the Financial Protection and Innovation Commissioner (e.g., transfer restrictions, escrow conditions, etc.), shares issued as a stock dividend thereon are subject to the same conditions. Thus, appropriate stock legends must be affixed to such shares. [Corps.C. § 25017(f)]

b. [7:270] **Stock dividends subject to qualification requirement:** Stock dividends that do not meet the requirements of Corps.C. § 25017(f) are treated as the "sale" of a security and qualification is required—unless some exemption is available. The dividend transaction is deemed a "change in the rights, preferences, privileges, or restrictions of or on outstanding securities" (requiring qualification by permit under Corps.C. § 25120). [Commr. Rule 260.017]

(1) [7:271] **Application:** The following are examples of stock dividends that will be treated as a "sale":

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [7:272] **Stock dividend OR cash:** If the shareholders are given the option to take cash in lieu of the stock dividend, it is not "payable solely in shares of common stock," and hence is treated as a "sale" under Corps.C. § 25017(f). [Commr. Rule 260.017]

(b) [7:273] **Stock dividends affecting other shareholders:** A stock dividend will also be considered a "sale" if the corporation has more than one class of voting stock outstanding; or, if the dividend is not payable solely in common stock on existing shares of common. Such stock dividends may affect the rights of existing shareholders, and therefore require qualification—unless otherwise exempt. [Commr. Rule 260.017]

1) [7:274] **Example:** Issuing preferred stock as a dividend on common shares may affect the rights of existing preferred stockholders—i.e., it may dilute their liquidation priority, and thus constitute a change in their rights, preferences and privileges. Such a change requires qualification under the Corporate Securities Law, unless some other exemption is established.

Likewise, where the existing preferred has voting rights, then issuing additional *common* shares as a stock dividend would require qualification (i.e., the additional common shares would dilute the voting rights of the preferred).

[7:275] ***Reserved.***

(2) [7:276] **Exemptions:** But many stock dividends are exempt from qualification:

(a) [7:277] **Limited offering:** The stock dividend may be exempt under the Corps.C. § 25102(f) "utility infielder" exemption (*¶ 5:256 ff.*) or the Corps.C. § 25102(n) "qualified purchaser" exemption (*¶ 5:304.6 ff.*). [See Commr. Rule 260.103]

(b) [7:277.1] **Exemptions based on federal preemption:** Stock dividends may also be exempt from qualification under state law provisions enacted to conform to the 1933 Act preemption provisions (*see ¶ 5:18.5 ff.*).

Most significantly:

- There is no qualification requirement for dividends of securities listed (or authorized for listing) on the New York Stock Exchange, NYSE American (successor to the American Stock Exchange), Nasdaq Global Market or Nasdaq Global Select Market, or securities equal or senior to the foregoing securities. [Corps.C. § 25100.1(a); SA § 18(a), (b), (d)(4) (15 USC § 77r(a),(b),(d)(4))]

- There is no qualification requirement, but only notice and fee requirements, for stock dividends issued (i) to "qualified purchasers," as defined by SEC rules (at present, the only such SEC rule is SEC Rule 256, which applies to Reg. A, Tier 2 offerings; *see ¶ 5:190.6*), or (ii) in reliance on Rule 506 (*¶ 5:172 ff.*) or such other SEC rules or regulations as may be issued in the future under SA § 4(a)(2) (15 USC § 77d(a)(2)). [Corps.C. § 25102.1(a), (d); SA § 18(a), (b) (15 USC § 77r(a),(b))]

(c) [7:278] **Mostly nonresidents affected:** If less than 25% of the shares adversely affected by the stock dividend are held by California residents, the stock dividend is exempt from qualification. [Corps.C. § 25103(b)] (For the rules for determining the number of "resident" shareholders affected, see Corps.C. § 25103(d).)

(d) [7:279] **No adverse change:** Even if more than 25% of the shares are held by California residents, the stock dividend is exempt if it does not "materially and adversely" affect the proportionate interests of the respective classes as to voting, dividends, liquidation, etc. [See Corps.C. § 25103(e)]

c. [7:280] **Stock splits:** Stock splits and reverse stock splits are normally exempt from qualification under the California Corporate Securities Law. [Corps.C. § 25103(f)]

[7:281] But qualification may be required where there is more than one class of shares outstanding, and the split would have a "material effect" on the proportionate interests of the respective classes as to voting, dividends or distributions. (Examples: increasing the number of shares entitled to vote, or to liquidation priorities; or where cash payment for fractional shares on a reverse stock split substantially alters proportionate interests.) [Corps.C. § 25103(f)(1), (3)]

[7:282] Also, a stock split of shares publicly traded is subject to qualification where it results in reducing the market price to less than $2 per share. [Corps.C. § 25103(f)(2)]

(1) [7:282.1] **Exemptions and preemption:** As with stock dividends, qualification of stock splits may be exempted under California law (*see ¶ 7:277*) or preempted by federal law (*see ¶ 7:277.1*).

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

5. [7:283] **Tax Consequences:** The general rule is that stock dividends and splits are *not taxable* to the shareholder upon receipt, and cause neither gain nor loss to the distributing corporation. They are treated as tax-exempt distributions by the corporation to its shareholders. [IRC § 305(a)—"gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock"]

a. [7:284] **Effect on shareholders' basis:** Shareholders realize neither gain nor loss on receipt of a stock dividend or split. Nor is there any change in the total basis of their investment. But their basis on their original shares must be divided between the old and new stock in accordance with their respective *market values at time of receipt* of the stock dividend. [IRC § 307; Treas.Reg. § 1.307-1(a)]

(1) [7:285] **Example:** S owns 1,000 shares of XYZ Corp. common stock, which originally cost $10,000, but now have a market value of $15,000. XYZ declares and distributes to S a stock dividend of 100 shares of its preferred stock, which have a market value of $5,000. (The total market value of the common and preferred combined is still $15,000, because the value of the common is reduced on account of the preferred stock dividend.) S's $10,000 basis is split up as follows: $6,666.67 to the common stock (2/3 of the basis, because the common is presently worth 2/3 of the total market value); $3,333.33 to the preferred. That is, each of S's 1,000 common shares now has a basis of $6.67; and each of his 100 preferred shares has a basis of $33.33.

(2) [7:286] **Effect:** The distribution of a stock dividend or split is not a taxable event. Rather, gain or loss is recognized only when the shares distributed are ultimately sold. That gain or loss will be computed, however, with respect to basis allocations reflecting the shares' value at time of receipt.

b. [7:287] **Taxable distributions:** There are a number of situations, however, in which stock dividends or splits may be taxed the same as cash or property dividends to the shareholders:

(1) [7:288] **Option given to receive cash:** If *any* shareholder is given the option to receive either cash or other property rather than additional shares, it is taxable as a cash dividend to *all* shareholders—even if all chose stock instead of cash. Giving such an option to even one shareholder results in all shares issued being taxed as ordinary income to the extent of the corporation's "earnings and profits." [IRC § 305(b)(1)]

(2) [7:289] **Disproportionate distributions:** If the stock dividend is part of a series of distributions whereby some shareholders receive cash or property and others receive more shares in the corporation, the shares so received will be taxable upon receipt as ordinary income. (For example, if XYZ has two classes of common stock, and pays cash dividends on one class and stock dividends on the other, the stock dividends are taxed the same as the cash dividends.) [IRC § 305(b)(2); Treas.Reg. § 1.305-3]

(3) [7:290] **Distributions of common and preferred to same class:** Where the distribution results in some common stockholders receiving common shares while others receive preferred shares, the entire distribution is taxable upon receipt as ordinary income. [IRC § 305(b)(3)]

(4) [7:291] **Dividends on preferred:** Any stock dividend on preferred stock is taxable as ordinary income, whether paid in common or additional preferred shares. [IRC § 305(b)(4)]

(a) [7:292] **Compare—stock splits:** But shares issued as a stock split would *not* be taxed; nor would shares issued merely to reflect an increase in the conversion ratio of *convertible* preferred stock, to take account of such a stock split. [See IRC § 305(b)(4)]

(5) [7:293] **Dividends of convertible preferred shares:** Distributions of convertible preferred stock to any class of shareholders are taxable *unless* shown to the IRS' satisfaction that it is *not* part of a "disproportionate distribution" (i.e., that it will not have the effect of distributing cash or property to some shareholders while increasing the proportionate stockholdings of others). [IRC § 305(b)(5)]

(6) [7:294] **Other transactions:** In addition to the foregoing, any other stock dividend that disproportionately increases the interests of certain shareholders over others may be taxed under regulations promulgated by the IRS. [IRC § 305(c); Treas.Reg. § 1.305-7]

[7:295] ***Reserved.***

c. [7:296] **Special rules as to "preferred stock bailouts" (IRC § 306):** Where preferred stock is distributed pro rata as a dividend on common stock, the transaction is normally not taxable (see IRC § 305(a), ¶ *7:283*). But it may be taxable as a

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

dividend if the shareholders later *sell* those preferred shares (either to an outsider or back to the corporation) to the extent the corporation has earnings and profits (*¶ 7:300 ff.*). This prevents common stockholders from "bailing out" corporate earnings and profits as a capital gain while retaining their same ownership interests in the corporation. [IRC § 306]

➪ [7:296.1] ***CAUTION—NO SIGNIFICANT TAX ADVANTAGE WHEN DIVIDENDS TAXED AT CAPITAL GAIN RATES*:** Under the current laws taxing dividends at capital gain rates (plus a 3.8% surtax applicable to higher income individuals; *see ¶ 7:178*), the advantage of using preferred stock to "convert" dividends to capital gains is largely ephemeral: Because the shareholder's basis in their common stock is allocated between the common and the new preferred (*¶ 7:284*), the otherwise taxable portion of proceeds received in a sale or redemption of the preferred stock is transformed into a tax-free return of capital *to the extent of the taxpayer's basis in the preferred stock*. But this advantage comes at the price of reducing the shareholder's basis in the *common* stock, thus increasing the amount of capital gain on any future "sale or exchange" of the common. Moreover, the same tax effect can usually be accomplished by simpler means, such as a partial redemption of common stock.

Nevertheless, corporate attorneys should remain aware of the possible effects of IRC § 306 in the event dividends once again are taxed at higher, ordinary income rates (*see ¶ 2:84*).

(1) [7:297] **What constitutes "Section 306 stock":** Any stock dividend received tax free under IRC § 305(a) (other than a dividend of common on common) is "Section 306 stock." [IRC § 306(c)] (The usual situation involves tax-free distributions of preferred stock on common, ¶ 7:296.)

(a) [7:298] **Not "common on common" dividends:** The simplest way to avoid IRC § 306 is to issue only common stock dividends on outstanding common shares. [IRC § 306(c)(1)(A)]

But whether dividend shares are common or preferred is determined by their rights, not by the label on the certificate. Thus, even "common" shares may be treated as "Section 306 stock" if they have *special liquidation preferences or redemption features* which could be used to "bail out" the corporate earnings to the shareholders. [See Rev.Rul. 76-386, 1976-2 CB 95]

(b) [7:299] **Preferred shares issued in reorganization:** "Section 306 stock" also includes preferred stock received in a tax-free reorganization (merger, recapitalization or other tax-free division or acquisition), if the *effect* of the transaction is substantially the same as a stock dividend. Such stock is "tainted" in the sense that a special tax is imposed upon its resale. [See IRC § 306(c)(1)(B)]

(2) [7:300] **Tax treatment of "Section 306 stock":** The tax treatment of "Section 306 stock" depends upon to whom the stock is ultimately sold:

(a) [7:301] **Upon redemption:** Where a shareholder sells "Section 306 stock" back to the corporation (i.e., a redemption or repurchase), it is treated as a cash or property dividend; i.e., dividend income to the extent of the corporation's *current or accumulated* earnings and profits *at the time of the redemption*. [IRC §§ 306(a)(2), 301(c)(1), 316(a)]

(b) [7:302] **Sale to third party:** If a shareholder sells "Section 306 stock" to anyone else (whether or not subsequently sold back to the corporation), the shareholder is deemed to receive dividend income on that part of the sale price equal to the shareholder's *ratable share* of the corporation's earnings and profits when the "Section 306 stock" was *issued*. The amount of the sale price exceeding that ratable share is applied to reduce the shareholder's basis in the stock, with any remainder taxed as a capital gain. [IRC § 306(a)(1)]

1) [7:303] **Example:** XYZ Corp. distributes a dividend of 1,000 shares of preferred stock to each of its three equal common stockholders, A, B and C. At that time, XYZ has accumulated earnings of $60,000.

A then sells its preferred shares to an outsider for $50,000.

Assume A's basis in the preferred stock is $5,000 (allocated according to market value of the common and preferred at time of receipt; *see ¶ 7:284*).

The first $20,000 of the $50,000 sale price is dividend income to A, since that was A's pro rata share of the corporation's $60,000 earnings and profits at the time of the preferred stock dividend. The next $5,000 is a tax-free return of capital (basis). The balance is a taxable capital gain.

2) [7:304] **Earnings and profits not reduced:** In a sense, § 306 operates as a penalty tax, because although the shareholder paid tax at dividend rates, *the corporation's earnings and profits are not reduced*. Therefore, later distributions by the corporation that might otherwise have been distributed tax-free (as a return of capital up to the amount of the shareholder's basis) will be a taxable dividend to the extent of earnings and profits.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(3) [7:305] **Exceptions:** The Code recognizes that certain preferred stock dividends serve legitimate investment purposes, rather than simply an attempt to "bail out" earnings at capital gains rates while retaining the same proportionate interest in the corporation. Consequently, where any of the following is established, the sale proceeds of "Section 306 stock" are *not* taxable in whole or in part as dividend income:

(a) [7:306] **Complete termination of investment:** The risk of dividend income is avoided if the selling shareholder sells their *entire* stock interest in the corporation (i.e., common as well as preferred). In such a case, there is clearly no attempted "bail out" of earnings while retaining the same ownership interest. [IRC § 306(b)(1)]

1) [7:307] **Attribution rules apply:** Note, however, that for the purpose of determining whether the selling shareholder has "completely terminated" their investment, the attribution rules of IRC § 318 apply (*see* ¶ *7:232*).

Thus, if any stock in the corporation is owned by other family members or related business entities, the sale proceeds may still be treated in whole or in part as an attempted "bail out"; i.e., dividend income to the selling shareholder. (In case of *redemptions* by the corporation, however, a waiver of the family member attribution rules may be available; see IRC § 302(c)(2), ¶ *7:233*.)

(b) [7:308] **Liquidations:** Shares redeemed in "partial" or "complete" liquidation of the corporation are exempt from IRC § 306. [IRC § 306(b)(1) & (2); *see* ¶ *7:244*]

[7:309] ***Reserved.***

(c) [7:310] **Nonrecognition transactions:** Nonrecognition transactions are also exempt under IRC § 306. For example, shares transferred as a *gift*, or in a corporate *reorganization*, do not result in dividend income to the transferor. [IRC § 306(b)(3)]

(But no charitable *deduction* may be taken for a charitable donation of "Section 306 stock" if a sale of the stock would have resulted in dividend income; see TAM 8930001 (1989).)

However, shares so transferred retain their "Section 306 taint" in the hands of the transferee. Thus, if the donee later sells the shares, the proceeds may be taxable as dividend income to the donee (unless some other exemption is established).

(d) [7:311] **Other legitimate purpose:** Finally, "Section 306 stock" disposed of in any other transaction may be exempt if the IRS is satisfied that tax avoidance was not one of its principal purposes. [IRC § 306(b)(4)]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. ¶ 8:1

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

[8:1] Overview

Fundamental or "organic" changes in the corporate structure may alter existing financial/control relationships and affect rights of creditors and minority shareholders. Therefore, such changes are subject to special requirements and procedures under corporate, tax and securities laws.

This chapter deals with the principal types of such changes:

• **Articles Amendments;**

• **Reorganizations** (recapitalizations, mergers, acquisitions and divisions);

• **Conversions;**

• **Sale of "Substantially All" Assets;** and

• **Dissolution.**

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 8-A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

A. Amendment of Articles

- 1. [8:3] Power to Amend
  - a. [8:4] Background—"vested rights" issue
  - b. [8:5] Modern rule
- 2. [8:6] Limitations on Power to Amend
  - a. [8:7] Express statutory limitations
    - (1) [8:8] Unlawful provisions
    - (2) [8:9] Initial directors, address, statutory agent
    - (3) [8:10] Changes affecting shares
  - b. [8:11] Equitable limitations ("fairness" doctrine)
  - c. [8:12] Requirements of Financial Protection and Innovation Commissioner
- 3. [8:13] Changes Requiring Amendment of Articles
  - a. [8:14] Change of corporate name
    - (1) [8:15] Selection of new name
  - b. [8:17] Change as to duration of corporation
    - (1) [8:18] Limiting corporate term
    - (2) [8:19] Extending corporate term
  - c. [8:20] Changes in purpose or powers
    - (1) [8:21] Close corporations
    - (2) [8:23] Professional corporations
    - (3) [8:25.1] SPCs
    - (4) [8:25.2] Benefit corporations
    - (5) [8:26] Nonprofit corporations
    - (6) [8:27] Other changes re corporate purpose or powers
  - d. [8:28] Changes in authorized capital
    - (1) [8:29] Changes required by statute
      - (a) [8:30] To accommodate shares under option or conversion rights
      - (b) [8:31] To effect stock split
        - 1) [8:32] Compare—stock dividends
        - 2) [8:33] Cross-refer
      - (c) [8:34] To reduce authorized capital or redesignate series after share repurchase
    - (2) [8:36] Creation of new class of shares
      - (a) [8:37.1] Effect on outstanding shares
    - (3) [8:38] Changes in rights, preferences, etc.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(4) [8:39] Changes in redemption provisions
(5) [8:40] Other changes affecting capitalization
e. [8:41] Changes affecting shareholder and director voting
(1) [8:42] Application
(2) [8:43] Amendments requiring more than majority approval
f. [8:44] Changes as to debt-holder voting rights
g. [8:45] Changes affecting preemptive rights
h. [8:46] Changes making shares assessable
i. [8:47] Changes affecting shareholder qualifications
4. [8:48] Procedure for Amending Articles
a. [8:49] Approval by board
(1) [8:50] No delegation to committee
(2) [8:51] Vote or written consent
b. [8:52] Approval by shareholders
(1) [8:54] Which shareholders must approve
(a) [8:55] Voting shares
(b) [8:56] Shares affected by amendment
1) [8:56.1] Even beneficial changes
(2) [8:57] Vote required
(a) [8:58] Articles requiring supermajority vote
(b) [8:59] Statutes requiring supermajority vote
1) [8:60] Amending existing supermajority vote provisions
2) [8:61] Changing to close corporation status
3) [8:62] Amendments re existing close corporations
a) [8:63] Articles may alter
4) [8:63.1] Changing SPC's special purpose
5) [8:63.2] Changing benefit corporation's specific purpose
6) [8:64] Making shares assessable
7) [8:65] Changing to nonprofit or cooperative status
8) [8:65.1] Changing to or from SPC
9) [8:65.2] Changing to or from benefit corporation
(3) [8:66] Vote or written consent
(4) [8:67] Exceptions—no shareholder approval required
c. [8:73] Filing certificate with Secretary of State
(1) Contents of certificate
(a) [8:74] Terms of amendment
(b) [8:75] Effect on outstanding shares
1) [8:75.1] Exception—par value changes
(c) [8:76] Duly adopted
1) [8:77] Before shares issued
2) [8:78] After shares issued
(d) [8:79] Compare—restated articles
(2) [8:80] Execution of certificate
(a) [8:81] Before shares issued
(b) [8:82] After shares issued
5. [8:83] Articles (or Bylaws) Amendments Requiring Permit From Financial Protection and Innovation Commissioner
a. [8:84] Exempt securities
b. [8:85] Exempt amendments
(1) [8:86] Amendments exempt under § 25102

(a) [8:87] Effect
(b) [8:88] Recapitalizations
(c) [8:89] Caution—notice requirement
(2) [8:90] Amendments exempt under § 25103
(a) [8:91] Particular amendments that may require permit
(b) [8:92] Amendments relating to statutory close corporations
(3) [8:93] Amendments authorizing new or additional shares
(4) [8:95] Stock splits
(a) [8:98] Exceptions—permit required
(b) [8:99] Compare—stock dividends
(c) [8:100] "Stock splits" vs. "stock dividends"
(5) [8:101] Amendments affecting nonresident shareholders
(a) [8:102] Determination of residency
(6) [8:103] Amendments in connection with bankruptcy reorganizations
c. [8:104] Application for permit
(1) [8:106] Filing fee
6. [8:107] Federal Securities Laws Affecting Amendments
7. [8:110] Compare—Restated Articles
a. [8:111] Procedure
(1) [8:112] Contents of certificate
(a) [8:113] Matters to be omitted
(2) [8:114] Board approval required
(3) [8:115] Certificate may also amend articles
(4) [8:116] Signature and verification
b. [8:117] Effect of restated articles
8. [8:117.1] Compare—Correction of Articles
a. Contents of certificate of correction
(1) [8:117.2] Title
(2) [8:117.3] Filing date of original instrument
(3) [8:117.4] Corrected provision
(4) [8:117.5] No modification of resolutions or consents
b. [8:117.6] Execution of certificate
(1) [8:117.7] Correction of original articles
(2) [8:117.8] Correction of amended or restated articles
c. [8:117.9] Effect on third parties

[8:2] Amending the articles of incorporation may be required for various reasons: Some amendments are mere "formalities" (e.g., to change the corporation's name). Others may substantially alter the financial or control structures of the corporation (e.g., to increase authorized capital, change voting rights). In addition, articles amendments may be required to effect certain types of corporate reorganizations (recapitalizations, mergers; *see ¶ 8:122*).

The rules and procedures for effecting such amendments are discussed in this section.

1. [8:3] **Power to Amend:** California corporations have broad powers to amend their articles of incorporation. Subject to limitations noted below (¶ 8:6 ff.), a corporation may amend its articles as often as it chooses, and in any respect it chooses. [Corps.C. § 900(a)]

a. [8:4] **Background—"vested rights" issue:** In former years, constitutional issues were sometimes raised by amendments that altered the rights of shareholders (e.g., by eliminating dividend or liquidation preferences of preferred shareholders). The affected shareholders often objected that such amendments impaired their "vested rights" under the original articles granted by the State. They argued that unless the State itself exercised its reserved powers to amend the articles (i.e., by changing the

statutes under which the corporation had been organized), the corporation had no power to do so. [See discussion in *Tu-Vu Drive-In Corp. v. Ashkins* (1964) 61 C2d 283, 286-288, 38 CR 348, 350-351]

b. [8:5] **Modern rule:** Under modern law, there is no real issue as to "vested rights" because the full power of the State to amend is conferred upon all California corporations. The Code now expressly provides: "It is the intent of the Legislature in adopting this section to exercise to the fullest extent the reserve power of the state over corporations and to *authorize any amendment* of the articles … regardless of whether any provision contained in the amendment was permissible at the time of the original incorporation of the corporation." [Corps.C. § 900(a) (emphasis added)]

2. [8:6] **Limitations on Power to Amend:** There are, however, various limitations imposed by law on a corporation's power to amend its articles of incorporation.

a. [8:7] **Express statutory limitations:** The Corporations Code itself contains several restrictions on a corporation's power to amend its articles.

(1) [8:8] **Unlawful provisions:** First of all, the amended articles may not include any provision that could not have been lawfully included in the original articles at the time of filing the amendment. Thus, any right guaranteed by law (e.g., notice of special meetings of the board) cannot be taken away by amending the articles. [Corps.C. § 900(a)]

(2) [8:9] **Initial directors, address, statutory agent:** Except to correct errors, a corporation may not amend its articles to change its initial street or mailing address, the names and addresses of its initial directors (if shown in the original articles), or the name and address of its initial agent for service of process. (However, all of these may be *deleted* by articles amendment after the corporation has filed the information statement required under Corps.C. § 1502; *see ¶ 4:474*.) [Corps.C. § 900(b)]

(3) [8:10] **Changes affecting shares:** If shareholder rights are to be changed, or there is to be any reclassification, cancellation or exchange of shares, the amendment must contain whatever provisions are required by law to effect such change. [Corps.C. § 900(a); *see ¶ 8:28*]

b. [8:11] **Equitable limitations ("fairness" doctrine):** In addition to the statutory limitations noted above (¶ 8:6 ff.), courts may intervene to protect minority shareholders from "unfairness" at the hands of the majority. Thus, an amendment that does not appear to be an exercise of business judgment in meeting the needs and exigencies of the corporate enterprise may be enjoined by a court of equity. While each case turns on its own facts, the more urgent the corporation's needs, the less likely courts are to enjoin amendments of the articles on this ground. [See *DeMello v. Dairyman's Cooperative Creamery* (1946) 73 CA2d 746, 751, 167 P2d 226, 228]

c. [8:12] **Requirements of Financial Protection and Innovation Commissioner:** Unless the securities or the transaction is exempt, an articles amendment that would "materially and adversely" affect any outstanding class of securities requires a permit from the Financial Protection and Innovation Commissioner (formerly the Business Oversight Commissioner). [Corps.C. §§ 25017(a), 25103(e), 25120; *see discussion at ¶ 8:83 ff.*]

3. [8:13] **Changes Requiring Amendment of Articles:** Not every change in the structure of a corporation requires amendment of its articles. Some changes can be effected simply by amending its bylaws (e.g., imposing transfer restrictions on its shares; *see ¶ 4:131*). And, in closely-held corporations, most changes can be effected by unanimous written agreement of the shareholders (*see ¶ 3:243*).

However, there are various matters that require formal amendment of the articles of incorporation, including the following:

a. [8:14] **Change of corporate name:** If the corporation wishes to change its name, an amendment of its articles of incorporation will be required. [Corps.C. §§ 202(a), 900; see also Corps.C. § 2602(a) (SPCs)]

(1) [8:15] **Selection of new name:** The same procedures and limitations re choice of name apply as in selecting the original name for the corporation; *see ¶ 3:402*.

➪ [8:16] ***PRACTICE POINTER:*** It may not be necessary to go through the procedures and formalities of amending the articles simply to enable the corporation to do business under a different name. As long as the new name is not likely to mislead the public, a corporation may do business under a *fictitious* name. For example, XYZ Corp. can do business as "Acme Industries" without amending its articles. [See *Pinkerton's, Inc. v. Sup.Ct. (Schrieber)* (1996) 49 CA4th 1342, 1347-1348, 57 CR2d 356, 359-360—corporation's fictitious name not a separate entity for pleading and procedure purposes]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- The only formality required to do business under a fictitious name is to file the certificate and publish the notice required by the fictitious business name statute (Bus. & Prof.C. § 17900 et seq.; *see ¶ 2:8*). This is essential to enable the corporation to sue under the fictitious name. Also, banks usually require proof of compliance with the statute for the corporation to open an account or endorse checks in that name.

- *Caution:* Officers and other agents who sign contracts on behalf of the corporation could be *personally liable* therefor unless the contract contains the corporation's full *legal* name or the other party is otherwise aware of the corporation's true identity (*see ¶ 6:283.1*).

b. [8:17] **Change as to duration of corporation:** Unless the articles provide otherwise, there is no limit on the term of a corporation's existence. [Corps.C. §§ 200(c), 204(a)(4); see also Corps.C. § 2600(c) (SPCs); *and ¶ 4:62*]

(1) [8:18] **Limiting corporate term:** Therefore, where the original articles make no mention as to the corporation's duration, and it is later decided to impose a limit thereon, an articles amendment is required to state the date on which it will expire. (If the corporation was formed before 8/24/1929, such an amendment does not require shareholder approval.) [Corps.C. §§ 200(c), 204(a)(4), 902(b)]

(2) [8:19] **Extending corporate term:** Conversely, an amendment may extend the duration of a corporation by removing a provision in the original articles terminating its existence as of a certain date. Such an amendment is permissible *even after expiration* of the term provided in the original articles … and thus may, in effect, "revive" the corporate existence and allow it to continue perpetually thereafter. [Corps.C. § 909]

c. [8:20] **Changes in purpose or powers:** Certain fundamental changes in the corporation's purpose and status require amendment of its articles of incorporation:

(1) [8:21] **Close corporations:** The articles of a statutory close corporation must contain certain statements (i.e., that its "shares of all classes may be held of record by no more than 35 persons"; and "this corporation is a close corporation"). [Corps.C. § 158; *see ¶ 3:238*]

[8:22] If an ordinary corporation desires to switch to close corporation status, its articles will have to be amended to include such statements. Conversely, if a close corporation wishes to become a regular corporation, these provisions will have to be deleted from its articles. [Corps.C. § 158(c), ¶ 3:240]

(2) [8:23] **Professional corporations:** If a corporation's business purpose is to engage in a professional practice, its articles must so state, together with a specific statement that it is a professional corporation within the meaning of § 13400 et seq. of the Corporations Code (*see ¶ 2:248 ff.*). [Corps.C. § 13404]

[8:24] It follows that if an ordinary corporation decides to become a professional corporation, its articles must be amended to include the required statements as to corporate purpose. [See Corps.C. § 13404]

[8:25] Conversely, if an existing professional corporation decides to change its status to an ordinary corporation, its articles must be amended to state that its purpose is "to engage in any lawful act or activity … *other than* the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code." [Corps.C. § 202(b)(1)(A) (emphasis added); *see ¶ 4:6*]

(3) [8:25.1] **SPCs:** The name of an SPC must contain the words "social purpose corporation" or an abbreviation thereof, and the articles must state that the corporation is a social purpose corporation. The articles must also contain a general purpose statement and a specific purpose statement. An articles amendment to effect these changes (and make any other conforming changes) is thus required if a corporation decides to become an SPC. [Corps.C. §§ 911(d)(1), 2602; *see ¶ 6:27.1, 9:22 ff.*]

Conversely, an SPC that wishes to change its status to a nonSPC corporation must amend its articles to delete the provisions relating to SPCs and to state that its purpose is "to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law …" (¶ 4:6). [Corps.C. § 3002, ¶ 9:276 ff.]

A *material alteration* of any special purpose of the SPC also requires an articles amendment. [Corps.C. § 3000(b), *¶ 9:262*]

(4) [8:25.2] **Benefit corporations:** The articles of a benefit corporation must state that the corporation is a benefit corporation and must also set forth any specific public benefit to be pursued by the corporation. An articles amendment is thus required if a corporation decides to become a benefit corporation. [Corps.C. §§ 14602, 14603, 14610(b), (d); *see ¶ 9:521 ff.*]

Conversely, a benefit corporation that wishes to terminate its status as a benefit corporation must amend its articles to delete both the statement that it is a benefit corporation and any stated specific public benefit. [Corps.C. §§ 14604(a), 14610(d); *see* ¶ *9:661 ff.*]

A change in the benefit corporation's *specific public benefit purpose* also requires an articles amendment. [Corps.C. § 14610(d), ¶ *9:641*]

(5) [8:26] **Nonprofit corporations:** An articles amendment is required if a for-profit corporation decides to convert to nonprofit status. The amendment would also have to delete the authorization for issuance of shares. (Ordinarily, the amendment would have to be approved by *all* of the outstanding shareholders of all classes; *see* ¶ *8:65*.) [Corps.C. § 911; see also Corps.C. §§ 3001 (SPCs, ¶ *9:263 ff.*), 14600(c) (benefit corporations, ¶ *9:500*)]

(6) [8:27] **Other changes re corporate purpose or powers:** Although unusual, the articles of a corporation that is not an SPC or benefit corporation may contain provisions *limiting* the business in which the corporation may engage or the powers it may exercise, or both (Corps.C. § 204(a)(6), *see* ¶ *4:14*). An SPC's articles may likewise contain provisions, in addition to its general and specific purpose provisions, limiting its business or powers (Corps.C. § 2603(a)(6), *see* ¶ *9:42*); and a benefit corporation's articles may contain provisions, in addition to its general and special public benefit purpose provisions, limiting its business or powers (Corps.C. §§ 204(a)(6), 2501, ¶ 9:3).

An articles amendment is required to change any such provisions. [Corps.C. §§ 900(a), 3000(b) (SPCs, ¶ *9:262*), 14610(d) (benefit corporations, ¶ *9:641*)]

d. [8:28] **Changes in authorized capital:** The original articles set the limit on the number and classes of shares that a corporation may issue. Further, if any class or series of shares is to have special rights, preferences, privileges or restrictions, these must be spelled out in the original articles; *see* ¶ *4:46*. If it becomes necessary later on to change the authorized capital structure of the corporation, the articles will have to be amended.

(1) [8:29] **Changes required by statute:** There are a few situations in which a corporation is *required* by statute to amend its articles so as to change the number of shares that it is authorized to issue.

(a) [8:30] **To accommodate shares under option or conversion rights:** Where the corporation has granted stock options, or issued securities with conversion rights, which if exercised call for issuance of more shares than presently authorized, it is required by statute to amend its articles to increase its authorized number of shares accordingly. [Corps.C. § 405(a); see *Monty v. Leis* (2011) 193 CA4th 1367, 1372-1373, 123 CR3d 641, 645—articles may be amended per § 405(a) *after* grant of stock option or issuance of convertible securities]

(b) [8:31] **To effect stock split:** Likewise, where the board of directors has authorized a stock split (or reverse stock split), an amendment of the articles is required *stating the effect on the outstanding shares* and, if necessary, increasing (or decreasing) the number of shares authorized. [Corps.C. §§ 182, 188]

1) [8:32] **Compare—stock dividends:** Stock dividends do not require articles amendments if the corporation already has enough authorized and unissued shares. However, a stock split (or reverse split) *always* requires amendment of the articles to state the effect on outstanding shares.

2) [8:33] **Cross-refer:** For a more detailed discussion of stock splits and stock dividends, *see* ¶ *7:245 ff.*

(c) [8:34] **To reduce authorized capital or redesignate series after share repurchase:** Where a corporation has repurchased some of its own shares and its articles *absolutely prohibit reissuing* the shares (a rare case), the articles must be amended to reduce the authorized number of shares. [Corps.C. § 510(b); *see* ¶ *7:140 ff.*]

If the articles prohibit reissuance only *as shares of the same series* (an even rarer case), the articles must be amended to reduce the authorized number of shares or redesignate the repurchased shares as authorized shares of a *different* series. [Corps.C. § 510(c); *see* ¶ *7:140.5 ff.*]

[8:35] ***Reserved.***

(2) [8:36] **Creation of new class of shares:** If a new class or series of shares is to be created, an amendment to the articles is required. The amendment must spell out the particular rights, preferences, privileges and restrictions of the new class or series (unless the articles specifically delegate to the board the authority to do so). [See Corps.C. § 202(g)(3); see also Corps.C. § 2602(g)(3) (SPCs); *and* ¶ *4:41 ff.*]

[8:37] As discussed later, any such amendment will require the approval not only by a majority of the voting shareholders, but also by any nonvoting shareholders whose rights may be affected by the creation of the new class or series. [Corps.C. § 903(a)(5); see also Corps.C. § 3000(a)(5) (SPCs); *and ¶ 8:56*]

(a) [8:37.1] **Effect on outstanding shares:** Unless the amendment specifically states its effect on outstanding shares, an amendment increasing the authorized shares from a single class (i.e., all common stock) to two classes, will have the following effect:

- The shares outstanding prior to the amendment are automatically considered to be the same number of shares of common stock;
- If only one of the two classes is designated "common" in the articles, that class is the common stock class;
- However, if *neither* class is designated "common" in the articles (or both classes are designated "common"), but one of them has limited or no voting rights, then the class whose voting rights are *not* limited is the common stock class. [Corps.C. § 907(c); *and see ¶ 3:77 ff.*]

➪ [8:37.2] ***PRACTICE POINTER:*** Be sure to specify the exact intended effect on all outstanding shares of any articles amendment increasing the number of outstanding share classes. Otherwise, the above provisions (¶ 8:37.1) will govern.

(3) [8:38] **Changes in rights, preferences, etc.:** Similarly, if the rights, preferences, privileges or restrictions applicable to any class or series of shares are to be changed, an amendment of the articles is required. Such amendment must be approved *both* by a majority of the voting shares and by a majority of each class or series affected by the change. [Corps.C. § 903(a)(4), (c); see Corps.C. § 3000(a)(4), (d) (SPCs); *and ¶ 8:56*]

(4) [8:39] **Changes in redemption provisions:** Likewise, any change as to the redeemability of outstanding shares, or change in redemption provisions contained in the original articles (e.g., sinking funds, redemption price, etc.) requires amendment of the articles. Again, such amendment must be approved both by a majority of the voting shares and by each class or series affected by the changes. [Corps.C. § 903(a)(4), (c); see Corps.C. § 3000(a)(4), (d) (SPCs); *and ¶ 8:56*]

(5) [8:40] **Other changes affecting capitalization:** The same rules apply to other changes in the capital structure of the corporation, including:

- *Exchanges*, reclassifications or cancellations of all or part of the shares of any class (other than as a stock split);
- Creating *conversion rights* whereby all or part of the shares of one class may be exchanged into the shares of another class (i.e., preferred into common);
- In the case of preferred shares, *dividing the class* into series having different rights, preferences, etc., or authorizing the board to do so;
- In the case of preferred shares, cancelling or reducing unpaid *accrued dividends*. [Corps.C. § 903(a)(7); see also Corps.C. § 3000(a) (SPCs); *and ¶ 8:56*]

e. [8:41] **Changes affecting shareholder and director voting:** The articles may contain provisions as to shareholder and director voting that alter the statutory rules otherwise applicable (*see ¶ 4:51*). To change such provisions in the articles (or to establish them if the original articles do not), amendments will be required.

(1) [8:42] **Application:** The following are changes that require articles amendment re shareholding and director voting:

- Granting the shareholders the right to determine or approve the consideration for which the corporation's shares may be issued. [Corps.C. § 204(a)(8); see also Corps.C. § 2603(a)(8) (SPCs); *and ¶ 4:102*]
- Requiring shareholder approval for corporate actions not requiring their approval as a matter of law. [Corps.C. § 204(a)(9); see also Corps.C. § 2603(a)(9) (SPCs); *and ¶ 4:122*]
- Requiring greater-than-majority of shareholders to constitute a quorum or to take shareholder action. [Corps.C. § 204(a)(5); see also Corps.C. § 2603(a)(5) (SPCs); *and ¶ 4:114*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- Requiring greater-than-majority of directors to constitute a quorum or to take board action. [Corps.C. § 204(a)(5); see also Corps.C. § 2603(a)(5) (SPCs); *and* ¶ *4:83*]

(2) [8:43] **Amendments requiring more than majority approval:** Where the articles already require greater-than-majority votes by the shareholders and/or directors, any amendment thereto will also require greater-than-majority approval unless the articles permit a lesser vote. [Corps.C. § 902(e); *see* ¶ *8:58*]

f. [8:44] **Changes as to debt-holder voting rights:** An amendment to the articles is required to establish or change provisions allowing debt-holders to vote for directors, or on any other matter. [Corps.C. § 204(a)(7); see also Corps.C. § 2603(a)(7) (SPCs); *and* ¶ *4:144*]

g. [8:45] **Changes affecting preemptive rights:** Shareholders have no preemptive rights to subscribe to any other shares issued by the corporation unless provided in the articles of incorporation. [Corps.C. § 204(a)(2); see also Corps.C. § 2603(a)(2) (SPCs); *and* ¶ *4:108*]

If such rights are not provided in the original articles, they may be added later by amendment. Such an amendment would require the approval of a majority of the voting shares. It would also have to be approved by a majority of the class or series to which the right was being granted (whether or not otherwise entitled to vote). This is because shareholder class approval is required for any "change" in the rights of the class—whether the change be for the better or worse. [Corps.C. § 903(a)(4); see also Corps.C. § 3000(a)(4) (SPCs); *and* ¶ *8:56*]

h. [8:46] **Changes making shares assessable:** A corporation has no power to levy assessments against outstanding shares unless such power is specifically granted in its articles of incorporation. [Corps.C. § 204(a)(1); see also Corps.C. § 2603(a)(1) (SPCs); *and* ¶ *4:106*]

If such power is not provided in the articles, it may be created by amending the articles. However, any such amendment must be approved by *all* (not simply a majority) of the outstanding shares affected thereby, whether or not otherwise entitled to vote. (Exception: Mutual water companies require approval by only two-thirds of the affected outstanding shares.) [Corps.C. § 904]

i. [8:47] **Changes affecting shareholder qualifications:** Although such provisions are unusual, the articles may impose special qualifications as to the persons who may be shareholders (e.g., employment by corporation, etc.). [Corps.C. § 204(a)(3); see also Corps.C. § 2603(a)(3) (SPCs); *and* ¶ *4:98*]

Such provisions could be added by amendment, but only as to shares not already outstanding. If the articles already contain such provisions, and it is desired to eliminate or change them, an articles amendment would of course be necessary. [Corps.C. § 900(a)]

4. [8:48] **Procedure for Amending Articles:** The procedure for amending articles of incorporation normally involves:

- Action by the board of directors;
- Approval by the shareholders; and
- Filing a certificate of amendment with the Secretary of State.

In addition, where shareholder rights are affected, the corporation may have to obtain a permit from the Financial Protection and Innovation Commissioner (formerly the Business Oversight Commissioner) *before* soliciting shareholder approval for the amendment, *unless* some exemption is available under the Corporate Securities Law. (*See discussion at* ¶ *8:83*.)

a. [8:49] **Approval by board:** The first step normally is action by the board of directors adopting and approving the proposed amendment (although the shareholders also could initiate such action). [See Corps.C. §§ 901, 902(a)]

(1) [8:50] **No delegation to committee:** The power to adopt or approve articles amendments is one of the few powers that the board of directors may *not* delegate to a committee of its own members (¶ *6:184*). (Such delegation would be permissible, however, as to those amendments *not* requiring shareholder approval; ¶ *8:67*.) [Corps.C. § 311(a)]

(2) [8:51] **Vote or written consent:** The board of directors may act either by formal resolution at a meeting of the directors or by unanimous written consent of all directors. [See Corps.C. § 307(b), ¶ *6:233*]

FORMS

- Directors' Resolution re Amendment of Articles of Incorporation, *see Form 8:A*.

• Unanimous Written Consent of Directors to Amendment of Articles of Incorporation, *see Form 8:B*.

b. [8:52] **Approval by shareholders:** Prior to issuance of shares, articles amendments can be adopted solely by the board of directors. (Or, if no directors have yet been elected or named in the original articles, amendments can be adopted by the incorporators; *¶ 4:400*.) [Corps.C. § 901]

Once shares have been issued, however, shareholder approval is required to amend the corporation's articles, except in the few instances noted below (¶ 8:67 ff.). Such shareholder approval may either follow or precede the directors' approval of the amendment. [Corps.C. § 902(a)]

[8:53] **Caution:** A *permit* may have to be obtained from the Financial Protection and Innovation Commissioner *before any solicitation of shareholder approval*, unless the shares or the transaction are exempt; *see discussion at ¶ 8:83 ff.*

(1) [8:54] **Which shareholders must approve:** An articles amendment must generally be approved *both* by a majority of the outstanding *voting* shares, and of each class or series *affected* by the proposed amendment that is not otherwise entitled to vote. [Corps.C. §§ 902(a), 903(a); see also Corps.C. § 3000(a) (SPCs)]

(a) [8:55] **Voting shares:** Approval by a majority of the outstanding voting shares is required, whether or not those shares are affected in any way by the amendment. [Corps.C. §§ 902(a), 903(c); see also Corps.C. § 3000(d) (SPCs)]

(b) [8:56] **Shares affected by amendment:** In addition, the proposed amendment must be approved by a majority of the outstanding shares in each class or series affected by such amendment in any of the ways enumerated in Corps.C. § 903(a) (Corps.C. § 3000(a) in the case of SPCs): i.e., amendments changing the number of shares in such class or series, or their rights or restrictions; or creating a new class of shares, etc. (*see ¶ 8:36 ff.*). Such approval is required whether or not the class or series involved otherwise has voting rights. [Corps.C. §§ 903(a), 402.5(a); see also Corps.C. § 3000(a) (SPCs); *and ¶ 3:112 ff.*]

1) [8:56.1] **Even beneficial changes:** Such class approval is required even if the proposed amendment is *beneficial* to the class or series involved (e.g., providing liquidation preferences where none previously existed). The change need not be adverse to require approval by the affected class. [See Corps.C. § 903(a); see also Corps.C. § 3000(a) (SPCs)]

(2) [8:57] **Vote required:** Ordinarily, approval by a majority of the outstanding voting shares and of each class affected by the proposed amendment is sufficient.

But there are a number of situations in which a *greater*-than-majority vote is required for shareholder approval:

(a) [8:58] **Articles requiring supermajority vote:** If the articles already contain provisions requiring a greater-than-majority (or unanimous) shareholder approval for amendments, such provisions are valid and enforceable. [Corps.C. § 204(a)(5); see also Corps.C. § 2603(a)(5) (SPCs)]

(b) [8:59] **Statutes requiring supermajority vote:** There are also a few situations in which a greater-than-majority vote is required by statute for shareholder approval of a proposed amendment to the articles:

1) [8:60] **Amending existing supermajority vote provisions:** Provisions presently in the articles requiring greater-than-majority votes by the shareholders or directors (either for amendments or other corporate actions) can be amended only upon approval by such greater-than-majority vote. [Corps.C. § 902(e)]

2) [8:61] **Changing to close corporation status:** Amendments to change an ordinary corporation into a statutory close corporation must be approved by *all* of the outstanding shares of all classes. [Corps.C. § 158(b); *see ¶ 3:239*]

3) [8:62] **Amendments re existing close corporations:** But amendments changing the number of shareholders in an existing statutory close corporation, or changing to *ordinary* corporation status, require approval by only *two-thirds* of the outstanding shares of all classes. [Corps.C. § 158(c); *see ¶ 3:240*]

a) [8:63] **Articles may alter:** The articles may permit such amendments on even a *lesser* vote (but not less than a majority of the outstanding shares), and may deny any class of shares the right to vote thereon. [Corps.C. § 158(c)]

But such provisions *cannot* be added by amending the articles, unless approved by the statutory percentages (¶ 8:59 ff.)—i.e., at least *two-thirds* of each class of shares outstanding, or any greater vote then required by the articles of incorporation. [Corps.C. §§ 158(c), 902(f)]

4) [8:63.1] **Changing SPC's special purpose:** An amendment that would *materially alter* any special purpose of an SPC that is stated in its articles must be approved by at least *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class regardless of whether that class is otherwise entitled to vote on the amendment. [Corps.C. § 3000(b); ¶ 9:262]

5) [8:63.2] **Changing benefit corporation's specific purpose:** An amendment changing any specific public benefit purpose stated in a benefit corporation's articles (*see ¶ 9:521 ff.*) must be approved by at least *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class or series of stock regardless of any limitation stated in the articles or bylaws on the voting rights of any class or series. [Corps.C. §§ 14601(d)(1), 14610(d); *see ¶ 9:641*]

6) [8:64] **Making shares assessable:** Except for mutual water companies, amendments making shares assessable require *unanimous* approval by all outstanding shares, regardless of whether they otherwise have the right to vote. [Corps.C. § 904; *¶ 8:46*]

7) [8:65] **Changing to nonprofit or cooperative status:** Similarly, amendments changing the corporation into a nonprofit or cooperative corporation require *unanimous* approval by all outstanding shares, regardless of whether they otherwise have voting rights. (Again, an exception is made for mutual water companies under specified conditions.) [Corps.C. § 911(a), (b), (c), (f); see also Corps.C. § 3001 (SPCs), ¶ 9:263 ff.]

8) [8:65.1] **Changing to or from SPC:** An amendment changing the corporation's status to an SPC must be approved by at least *two-thirds* (or greater vote if required in the articles) of the outstanding shares of each class of stock. [Corps.C. § 911(d)(2)]

Conversely, an amendment changing an SPC to a nonSPC corporation must be approved by at least *two-thirds* (or greater vote if required in the articles) of the outstanding shares of each class regardless of whether the articles entitle that class to vote thereon. [Corps.C. § 3002; *see ¶ 9:276*]

9) [8:65.2] **Changing to or from benefit corporation:** An amendment changing a corporation to a benefit corporation (¶ 9:531), or changing from a benefit corporation to a nonbenefit corporation (¶ 9:661 ff.), must be approved by at least *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class or series of stock regardless of any limitation in the articles or bylaws on the voting rights of any class or series. [Corps.C. §§ 14601(d)(1), 14603(a), 14604, 14610(d)]

(3) [8:66] **Vote or written consent:** Shareholder approval may be by formal vote at a properly-noticed shareholders' meeting; or by written consent of the holders of the number of shares required for such approval. [Corps.C. §§ 194, 603(a)]

• ***FORM:*** Written Consent of Shareholders to Amendment of Articles of Incorporation, *see Form 8:C*.

(4) [8:67] **Exceptions—no shareholder approval required:** There are a few amendments that can be adopted by the board of directors alone—i.e., *without* shareholder approval. Basically, these are situations where the articles amendment is required as a matter of law, or to implement previously-approved shareholder action:

• [8:68] **Amendment to effect stock split:** If the corporation has only a *single class* of shares outstanding, an amendment to effect a "stock split" requires only board approval. (But a "reverse stock split" still requires shareholder approval.) [Corps.C. §§ 902(c), 903(a)(2); see also Corps.C. § 3000(a)(2) (SPCs); *and ¶ 7:262*]

• [8:69] **Amendment to provide shares for plans previously approved by shareholders:** If the shareholders have *previously approved* the granting of *stock options* or the issuance of *convertible securities*, the board alone can adopt any amendment necessary to implement such plans (i.e., to increase the number of shares the corporation is authorized to issue). [Corps.C. § 405(b)]

• [8:70] **Amendment to reduce authorized capital or redesignate series after share repurchase:** Where a corporation has repurchased some of its own shares, and its articles *absolutely prohibit reissuing* the shares (a rare case), the articles must be amended to reduce the authorized number of shares. If the articles prohibit reissuance only *as shares of the same series* (an even rarer case), the articles must be amended to reduce the authorized number of shares or redesignate the repurchased shares as authorized shares of a *different* series. In either event, the board alone can effect such amendment; no separate shareholder approval is required. [Corps.C. § 510(b), (c), (f)]

• [8:71] **Amendment deleting close corporation status:** A close corporation, upon learning that there are more than 35 shareholders of record, *must* amend its articles to delete the special close corporation statements. Such amendment can be adopted by the board alone, without shareholder approval. [Corps.C. § 158(e)]

• [8:72] **Amendment deleting initial directors, etc.:** An amendment deleting from the articles the initial street or mailing address of the corporation, or the name and address of the corporation's initial agent for service of process, can be adopted by the board without shareholder approval. Likewise, if the articles set forth the names and addresses of the initial directors (which is not required, *see ¶ 4:67*), an amendment deleting their names can be adopted by the board

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

without shareholder approval. [Corps.C. § 902(d)] (But filing the certificate of amendment deleting the corporation's initial address, or the name or address of the initial agent for service of process, is not proper unless the corporation has filed with the Secretary of State the information statement required by Corps.C. § 1502; see Corps.C. § 1502(e).)

c. [8:73] **Filing certificate with Secretary of State:** The corporation is required to file with the Secretary of State a certificate as to any amendment of its articles. [Corps.C. §§ 905, 906]

A filing fee (currently $30) is payable, for which the Secretary of State will provide a copy of the certificate of amendment without additional charge. [Gov.C. §§ 12185, 12186(p)]

The amendment becomes effective upon filing, as does any change in share rights addressed in the amendment. A certified copy of the certificate of amendment constitutes prima facie evidence that the amendment was duly adopted. [Corps.C. § 908]

(1) Contents of certificate

(a) [8:74] **Terms of amendment:** The certificate must establish exactly how the articles are being amended. It may do so by stating that the articles are amended to read as set forth therein in full (i.e., restating the entire articles to reflect the changes made). Or, it may set forth just the provisions that are being added. Or, it may identify particular provisions of the original articles (by their numerical designation or by stating their wording), and state that they are stricken or are amended to read as set forth in the certificate. [Corps.C. § 907(a)]

(b) [8:75] **Effect on outstanding shares:** In addition, if the purpose of the amendment is to effect a stock split, reverse stock split, or to reclassify, exchange or otherwise change outstanding shares, the amended articles must state the effect on the outstanding shares. [Corps.C. § 907(b)]

1) [8:75.1] **Exception—par value changes:** Amendments which add, change or eliminate a stated par value need not state the effect of the amendment on outstanding shares. [Corps.C. § 907(d); *but see* *¶ 4:47*]

(c) [8:76] **Duly adopted:** The certificate must also state whatever facts are necessary to establish that it has been duly adopted by the corporation:

1) [8:77] **Before shares issued:** If the amendment was adopted before shares have been issued, the certificate must so state; and also that the amendment has been approved by a majority of the directors or incorporators, as the case may be. (A certificate by the incorporators must also state that no directors were named in the original articles or yet elected.) [Corps.C. § 906]

2) [8:78] **After shares issued:** If shares have already been issued, the certificate must state the amendment has been approved by the board of directors. [Corps.C. § 905(b)]

If the amendment requires shareholder approval (*¶ 8:54*), the certificate must also state:

• That the amendment was approved by the required vote of shareholders;

• The total number of outstanding shares of each class entitled to vote with respect to the amendment; and

• That the number of shares of each class voting in favor of the amendment equaled or exceeded the vote required, specifying the percentage vote required of each class entitled to vote. [Corps.C. § 905(c)]

If the amendment does not require shareholder approval (*¶ 8:67*), the certificate must state the facts showing this to be the case. [Corps.C. § 905(d)]

(d) [8:79] **Compare—restated articles:** A corporation may at any time file a "Restated Articles of Incorporation"—to incorporate the text of *previous* amendments. Such restated articles supersede for all purposes both the original articles and the previous amendments. [Corps.C. § 910(a), (d); *see* *¶ 8:110*]

(2) [8:80] **Execution of certificate:** To be acceptable for filing, the certificate must be signed and verified.

(a) [8:81] **Before shares issued:** If the amendment is made before shares have been issued, the certificate must be signed and verified by a majority of the directors. If no directors have yet been elected, and none were named in the original articles, the certificate can be signed and verified by a majority of the incorporators. [Corps.C. §§ 901, 906]

(b) [8:82] **After shares issued:** After shares have been issued, an "officers' certificate" is required; i.e., the certificate of amendment must be signed by and verified by the chairperson of the board, president or any vice president *and* by the secretary, chief financial officer, treasurer or any assistant secretary or treasurer. [Corps.C. §§ 902, 905, 173]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

FORM: Certificate of Amendment of Articles of Incorporation, *see Form 8:D*.

5. [8:83] **Articles (or Bylaws) Amendments Requiring Permit From Financial Protection and Innovation Commissioner:** Amendments that would change the rights, preferences, privileges or restrictions of *outstanding* shares constitute a “sale” of securities under the Corporate Securities Law. Therefore, qualification is required, unless the shares themselves or the amendment transaction falls within one of the available exemptions described below (¶ 8:84 ff.). [Corps.C. § 25017(a); see also Corps.C. § 25120]

Qualification may also be required for amendment of the *bylaws* where the amendment would affect the rights, preferences, privileges or restrictions on outstanding shares (e.g., imposing or deleting transfer restrictions on outstanding shares). [See Corps.C. § 25103(e)(11)]

a. [8:84] **Exempt securities:** No permit is required for amendments affecting securities otherwise exempt from qualification under the Corporate Securities Law. This applies primarily to, e.g., securities issued by regulated institutions (banks, savings and loans, etc.), charities, governmental agencies and the like, and also securities listed on national securities exchanges. *See ¶ 5:195.5 ff.*

b. [8:85] **Exempt amendments:** The Code and the Commissioner's Rules exempt the following types of amendments:

(1) [8:86] **Amendments exempt under § 25102:** Changes in the rights, preferences, privileges or restrictions on outstanding shares are exempt if the transaction, had it involved the issuance of new securities, would have fallen within one of the Corps.C. § 25102 exemptions—most importantly, the Corps.C. § 25102(f) “limited offering” exemption (*¶ 5:256 ff.*) or the Corps.C. § 25102(n) “qualified purchaser” exemption (*¶ 5:304.6*). [Commr. Rule 260.103]

(a) [8:87] **Effect:** Thus, as long as the shareholders meet the qualifications of Corps.C. § 25102(f) (no more than 35 “counted” purchasers, preexisting relationship, etc.) or Corps.C. § 25102(n) (institutional and “sophisticated” purchasers), no permit is required. An articles amendment is exempt even if it would significantly impair the rights of existing shares (e.g., by changing dividend rates, liquidation priority, etc.).

(b) [8:88] **Recapitalizations:** Likewise exempt are amendments to effect a recapitalization of the corporation (*see ¶ 8:119*), where the new securities exchanged in the transaction would have been exempt as an original issuance under Corps.C. § 25102. [Commr. Rule 260.103]

(c) [8:89] **Caution—notice requirement:** Remember that there are notice requirements for the exemptions under Corps.C. §§ 25102(f), 25102(h) and 25102(n). Thus, where the amendment is claimed exempt under these sections, the prescribed notice must be given. [See Commr. Rule 260.103(b); *¶ 5:249 ff., 5:304.24 ff.*]

(2) [8:90] **Amendments exempt under § 25103:** In addition, the Code specifically exempts “any change in the rights, preferences, privileges or restrictions” on outstanding shares, *unless* it is one of those listed in the following paragraph *and* it “materially and adversely” affects a class of shareholders. [Corps.C. § 25103(e)]

(a) [8:91] **Particular amendments that may require permit:** The Code enumerates the following types of amendments that will require a permit *if* they “materially and adversely” affect the rights of outstanding shareholders (and are not otherwise exempt):

• Changes in assessment provisions;

• Changes in dividend or liquidation rights;

• Changes in redemption or sinking fund provisions, or redeemability of shares;

• Changes in voting rights (e.g., eliminating cumulative voting and/or creating staggered terms for directors of “listed” corporations, Corps.C. § 301.5);

• Changes in conversion rights;

• Changes in preemptive rights;

• Changes as to relative priorities of outstanding shares;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Changes as to transfer restrictions (in articles or bylaws);

• Changes as to right to call special shareholder meetings;

• Changes affecting shares of corporations organized primarily to provide services or facilities to its shareholders (e.g., a mutual water company). [Corps.C. § 25103(e)]

(b) [8:92] **Amendments relating to statutory close corporations:** The Code also enumerates various amendments relating to statutory close corporations that are deemed *not* "material and adverse" (and therefore exempt from qualification under Corps.C. § 25103):

• Amendments to convert an ordinary corporation to a statutory close corporation (since such amendments already require consent of all outstanding shares; *see ¶ 8:61*);

• Amendments to convert a statutory close corporation to an ordinary corporation (since such amendments already require approval by at least *two-thirds* of the outstanding shares; *see ¶ 8:62*);

• Amendments required by statute upon the involuntary cessation of close corporation status (e.g., upon acquiring too many shareholders or termination of the shareholders agreement; *see ¶ 8:71*). [Corps.C. § 25103(e), last sentence]

(3) [8:93] **Amendments authorizing new or additional shares:** An amendment which merely *authorizes* additional shares or shares senior to an outstanding class of shares does not require qualification. This is true even if the newly-authorized shares have priority over (or dilute) existing shares. [Commr. Rule 260.103.1]

[8:94] However, the actual *offer or sale* of the newly-authorized shares would have to be qualified or otherwise exempt, as any other stock issuance (*see ¶ 5:195a*). [Commr. Rule 260.103.1]

(4) [8:95] **Stock splits:** Amendments to effect a "stock split" or "reverse stock split" are exempt, subject to the exceptions noted below (¶ 8:98). Such amendments simply change the *number* of shares held by each outstanding shareholder, and do not change rights or restrictions. [See Corps.C. § 25103(f)]

[8:96] For purposes of Corps.C. § 25103(f), a "stock split" or "reverse stock split" means "the subdivision or combination of previously outstanding shares of stock (whether or not including authorized and unissued shares) into a greater or lesser number of shares of the same class, effected by an amendment to the charter documents of the issuer." [Commr. Rule 260.103.2]

[8:97] (If the existing share certificates are subject to a legend condition restricting transfer, any shares issued subject to a stock split or reverse stock split must carry the same legend restriction; Commr. Rule 260.103.5.)

(a) [8:98] **Exceptions—permit required:** But qualification by permit may be required if:

• There is more than one class of shares outstanding, and the split would have a "material effect" on the proportionate interests of the respective classes, as to voting, dividends or distributions;

• In a reverse split, the corporation has the option of paying cash for fractional shares, the result of which might substantially alter the proportionate interests of the existing shareholders;

• The shares are publicly traded and the effect of the split would be to create shares selling for $2 or less (i.e., "penny stock"). [See Corps.C. § 25103(f)]

(b) [8:99] **Compare—stock dividends:** A stock dividend is also normally exempt from qualification with the Financial Protection and Innovation Commissioner. But there may be situations in which a stock dividend would be subject to qualification requirements: e.g., where there are several classes of shares outstanding and the dividend would effect a "material" change in the rights of one class (e.g., issuing additional preferred shares as a dividend on the common so as to dilute the preferences of the existing preferred shareholders). [Corps.C. §§ 25017(f)(2), 25103(e); Commr. Rule 260.017; *see ¶ 7:270*]

(c) [8:100] **"Stock splits" vs. "stock dividends":** *See detailed discussion at ¶ 7:245 ff.*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(5) [8:101] **Amendments affecting nonresident shareholders:** Even "materially adverse" articles amendments are exempt from qualification with the Financial Protection and Innovation Commissioner if *less than 25%* of the affected shares are held by California residents. [Corps.C. § 25103(b)]

(a) [8:102] **Determination of residency:** The shareholders' residence is determined by the addresses shown on the corporation's books. Shares held (to the knowledge of the corporation) by broker-dealers or their nominees, or any one controlling more than 50% of the class, are *excluded* in applying the 25% test.

For example, if 60% of the outstanding shares are held by a New York resident, the New York resident's shares are excluded; the question then is whether 25% of the remaining 40% (i.e., 10% of the total outstanding shares) is held by California residents. [Corps.C. § 25103(b), (d)]

(6) [8:103] **Amendments in connection with bankruptcy reorganizations:** Also exempt from qualification are changes in the rights of outstanding shares in connection with reorganization of a corporation in *bankruptcy* proceedings. [See Corps.C. § 25102(k); and Commr. Rule 260.103(a)(1)]

c. [8:104] **Application for permit:** If neither the shares nor the articles amendment is exempt from qualification, the corporation must obtain a permit from the Financial Protection and Innovation Commissioner *before any general solicitation of shareholder approval* of the amendment. (Negotiations and agreements prior thereto are permissible, as long as made subject to such approval. See Corps.C. § 25103(a); and Commr. Rule 260.121.)

The application procedure is substantially the same as involved with the sale and issuance of securities (*see ¶ 5:315 ff.*). If any proxy material is to be distributed to the shareholders in connection with the proposed amendment, copies thereof must be included with the application for the permit. [Corps.C. § 25148; Commr. Rule 260.121, Item 15(D)]

[8:105] ***Reserved.***

(1) [8:106] **Filing fee:** The statutory filing fee is $200 for an application in connection with a change affecting outstanding shares (including stock splits and stock dividends). There is an additional fee (1/5 of 1% of value) with a $2500 maximum, if the transaction involves the exchange of securities. [See Corps.C. § 25608(h)]

6. [8:107] **Federal Securities Laws Affecting Amendments:** Articles or bylaws amendments effecting a change in the rights, preferences, privileges or restrictions of outstanding securities are not considered a "sale" or "offer to sell" a security and hence do not require registration under the 1933 Act. [SA § 2(a)(3)]

[8:108] But the solicitation of shareholder approval of any such amendments by a corporation subject to the reporting requirements of the 1934 Securities Exchange Act is subject to the federal proxy rules, including Rule 14a-9, which prohibits materially misleading statements or omissions from proxies, proxy statements, notices of meetings and other communications with respect to shareholder solicitations. [SEA § 14; and SEC Reg. 14A]

[8:109] And if the amendment has the effect of creating a "new" security, the antifraud rules of Section 10(b) of the 1934 Act and Rule 10b-5 thereunder apply to any representations made by the corporation in soliciting shareholder approval (whether or not the securities are subject to federal registration requirements).

7. [8:110] **Compare—Restated Articles:** Where there have been several amendments to the original articles, the corporation may find it useful to *restate* its articles in a single document. The Code provides a simplified procedure for this purpose. [Corps.C. § 910]

a. [8:111] **Procedure:** A certificate must be filed on behalf of the corporation with the Secretary of State, entitled "RESTATED ARTICLES OF INCORPORATION OF (name of corporation)."

(1) [8:112] **Contents of certificate:** The certificate must set forth the full text of the articles *as amended to date* (except the matters noted below; ¶ 8:113). [Corps.C. § 910(a)]

It must also include the provisions of any "certificate of determination" filed subsequent to the original articles. [Corps.C. § 910(c)]

(a) [8:113] **Matters to be omitted:** Provisions deleted by earlier amendments are excluded, of course. Also omitted are the signatures and acknowledgments of the original incorporators, as well as any statements regarding the effect of previous amendments on outstanding shares (e.g., a prior amendment to effect a stock split). And where the corporation has already filed its first annual information statement setting forth its directors, agent for service of process and street

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

address (and mailing address, if different), the names and addresses of the initial directors and agent, as well as the initial street and mailing address, are omitted from the restated articles. [Corps.C. § 910(a)]

(2) [8:114] **Board approval required:** The certificate must be approved by a majority of the corporation's directors (or, if no shares have been issued and no directors elected or named in the articles, by a majority of the incorporators). Shareholder approval is *not* required … unless the certificate itself further amends the articles (*see ¶ 8:115*). [Corps.C. § 910(b)]

(3) [8:115] **Certificate may also amend articles:** A certificate of restated articles may also include *new* amendments to the articles. [Corps.C. § 910(b)]

Of course, in such event, it becomes subject to the rules governing articles amendments: i.e., the certificate must set forth the same information as required in a certificate of amendment (Corps.C. §§ 905-907, ¶ *8:74*); the restated articles may require *shareholder approval* (Corps.C. § 910(b)); and, unless exempt, qualification by permit may be required under the Corporate Securities Law.

(4) [8:116] **Signature and verification:** Where no shares have been issued, the certificate must be signed and verified by a majority of the *directors* (or by a majority of the *incorporators* if no directors have been elected or named in the articles). [Corps.C. §§ 910(a), 901, 906]

Where shares have been issued and directors named or elected, the certificate must be signed and verified by *officers* of the corporation in the same manner as an articles amendment (*see ¶ 8:82*). [Corps.C. §§ 910(a), 173]

b. [8:117] **Effect of restated articles:** Once filed, the certificate of restated articles *supersedes* the original articles and any certificate of determination or amendments filed prior thereto. [Corps.C. § 910(d)]

8. [8:117.1] **Compare—Correction of Articles:** A misstatement of fact or defect contained in any document filed with the Secretary of State, including the articles (or an amendment or restatement of the articles), may be corrected by filing a *certificate of correction*. [Corps.C. § 109(a)]

a. Contents of certificate of correction

(1) [8:117.2] **Title:** A certificate of correction must be headed: "Certificate of Correction of …" (*here insert title of document being corrected—e.g., Articles of Incorporation—and the name of the corporation*). [Corps.C. § 109(a)]

(2) [8:117.3] **Filing date of original instrument:** The certificate must state the date the instrument being corrected was filed. [Corps.C. § 109(c)(2)]

(3) [8:117.4] **Corrected provision:** The provision(s) in the instrument as corrected must then be set forth; and, if a defect in *execution* of the original instrument is being corrected, the certificate must specify how the execution was defective. The provisions being corrected must be identified in the same manner as when amending the articles (see Corps.C. § 109(a), ¶ *8:74*). [Corps.C. § 109(c)(3)]

(4) [8:117.5] **No modification of resolutions or consents:** Finally, where applicable, the certificate must provide that it does not alter the wording of any resolution or written consent adopted by the directors or shareholders. [Corps.C. § 109(c)(4)]

b. [8:117.6] **Execution of certificate:** To be acceptable for filing, the certificate of correction must be signed and verified. [Corps.C. § 109(b)]

(1) [8:117.7] **Correction of original articles:** If the certificate corrects the original articles, it must be signed and verified by an officers' certificate (*see ¶ 8:82*) or by a majority of the incorporators. [Corps.C. § 109(b)]

(2) [8:117.8] **Correction of amended or restated articles:** A certificate of correction for amended or restated articles must be signed and verified by an officers' certificate (¶ *8:82*). [Corps.C. § 109(b)]

c. [8:117.9] **Effect on third parties:** Filing a certificate of correction does not alter the effective duration of the instrument being corrected. Nor does the certificate extinguish any rights or liabilities arising from the error or defect being corrected, except as to persons who have not *detrimentally relied* on the original instrument. [Corps.C. § 109(e)]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 8-B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

B. Corporate Acquisitions and Reorganizations

1. [8:118] Introduction
  a. [8:118.1] Acquisition methods
    (1) [8:118.2] Stock purchase
      (a) [8:118.3] Stock-for-stock exchange
    (2) [8:118.4] Asset purchase
      (a) [8:118.5] Assets purchased in exchange for stock
    (3) [8:118.6] Merger
  b. Considerations affecting choice of acquisition method
    (1) Corporate law considerations
      (a) [8:118.7] Shareholder approval requirements
        1) [8:118.8] Dissenter's rights
      (b) [8:118.9] Liabilities acquired
      (c) [8:118.10] Contract restrictions on transferability of assets
        1) [8:118.11] Using merger or stock acquisition to bypass transfer restrictions
      (d) [8:118.12] Bulk sale restrictions
      (e) [8:118.13] Antitrust restrictions
      (f) [8:118.14] Covenants not to compete
        1) [8:118.14a] Geographic/temporal limits
        2) [8:118.14b] Scope of covenant limited to protection of purchased business
        3) [8:118.14e] Limitation—post-employment noncompete covenants
        4) [8:118.14f] Tax treatment—payments amortizable
      (g) [8:118.15] Special employee notice requirements (layoffs, plant closures, relocations)
    (2) [8:118.16] Securities law considerations
    (3) [8:118.17] Tax considerations
      (a) [8:118.18] Tax-free acquisitions
      (b) [8:118.19] Sales taxes
      (c) [8:118.20] Property tax reassessments
      (d) [8:118.20a] Application of documentary transfer tax
  c. [8:118.21] Accounting treatment
    (1) [8:118.22] Goodwill
    (2) [8:118.23] "Pooling of interests" method abolished
  d. [8:118.26] Corporate "reorganizations"
  e. [8:118.31] Acquisition and reorganization expenses generally *not* deductible

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) Application
(2) [8:118.32] Compare—investigation expenses
(3) [8:118.33] Compare—“success-based fee”
(a) [8:118.34] 70%/30% “safe harbor” allocation
(b) [8:118.35] “Milestone payment”
2. [8:119] Recapitalizations
a. [8:120] Procedure
(1) [8:121] Shareholder approval
(2) [8:123] No dissenters' rights
b. [8:124] Tax treatment
(1) [8:125] Tax-free exchange generally
(2) [8:126] Limitations
c. [8:131] Forms of recapitalization
(1) [8:132] Exchanges of “new” preferred for “old” common
(a) [8:133] Purpose
(b) [8:134] Example
1) [8:134.1] *CAUTION*
(c) [8:135] Amendment of articles
(d) [8:136] Tax considerations
1) [8:137] Caution—transfer of less than all stock
2) [8:137.1] Caution—“nonqualified preferred stock” taxable
a) [8:137.2] Exception for “family-owned corporation”
(2) [8:138] Exchanges of “new” preferred for “old” preferred
(a) [8:139] Purpose
(b) [8:140] Amendment of articles
(c) [8:141] Tax considerations
1) [8:141.1] “Nonqualified preferred” taxable
2) [8:142] Compare—effect of dividend
(3) [8:143] Exchanges of “new” common for “old” preferred
(4) [8:144] Exchanges of “new” common for “old” common
(5) [8:145] Exchanges of “new” stock for “old” debt
(a) [8:145.1] *Caution*—possibility of income to corporation
(6) [8:146] Exchanges of “new” debt securities for “old” debt
(a) [8:147] Tax considerations
(7) [8:150] Compare—exchanges of “new” debt for “old” stock
(8) [8:152] Plan essential
d. [8:152.6] Securities law requirements
(1) [8:153] Federal and state exemptions for exchange with existing security holders
(a) [8:153.1] Comment
(2) [8:153.5] Other *state law* exemptions
(a) [8:153.6] Securities of “listed” corporations
1) [8:153.7] Proxy rules applicable
(b) [8:153.8] SEC Rule 506 and “qualified purchasers”
(c) [8:156] Exemptions pertaining to recapitalizations
1) [8:156.1] Notice requirement
(3) [8:157] Qualification procedure
(a) [8:158] Commissioner's standards
(b) [8:159] Hearings
(c) [8:160] Soliciting shareholder approval

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- 3. [8:161] Mergers
  - a. [8:163] Types of mergers
    - (1) [8:164] Straight merger
    - (2) [8:165] Triangular merger
    - (3) [8:166] Reverse triangular mergers
    - (4) [8:167] Short-form mergers
  - b. Procedure to effect merger
    - (1) [8:168] Plan or agreement of merger
      - (a) [8:169] Parties
      - (b) [8:170] Contents
        - 1) [8:170.1] Terms may be dependent on facts ascertainable outside agreement
        - 2) [8:170.2] Terms may be dependent on extrinsic agreement
          - a) [8:170.3] Shareholder approval of amendments to extrinsic agreements
            - 1/ [8:170.4] Change in shareholder rights, liabilities
            - 2/ [8:170.5] Change in principal terms of merger agreement
          - b) [8:170.6] Copies must be maintained
        - 3) [8:170.7] Agreement must provide fair treatment for fractional share interests
        - 4) [8:170.8] Equal treatment for all shares of same class
          - a) [8:170.9] Exception—shares held by constituent corporation
      - (c) [8:171] Execution
    - (2) [8:172] Board approvals
      - (a) [8:172.1] Caution
      - (b) [8:172.1a] Approval of parent's share issuance
      - (c) [8:172.2] Agreement may be made binding and exclusive
        - 1) [8:172.3] Board duties re competing offers (publicly-held companies)
          - a) [8:172.3a] Comment
      - (d) [8:172.5] Mergers proposed by insiders
        - 1) [8:172.6] Who is an “interested party”
          - a) [8:172.7] Exception—corporations with fewer than 100 shareholders
          - b) [8:172.8] Exception—mergers qualified by permit
            - 1/ [8:172.8a] Comment
        - 2) [8:172.9] Independent fairness opinion
          - a) [8:172.10] Opining person's qualifications
          - b) [8:172.11] Delivery of opinion
        - 3) [8:172.12] Competing offers
          - a) [8:172.13] Insider proposal delayed pending shareholder action on competing offer
          - b) [8:172.14] Improving insider offer
    - (3) [8:173] Shareholder approvals
      - (a) [8:173.1] Before or after board approval
      - (b) [8:174] Mergers requiring greater-than-majority approval
        - 1) [8:175] Articles so require
        - 2) [8:176] Disappearing close corporation
        - 3) [8:176.1] Surviving SPC and disappearing nonSPC
        - 4) [8:176.2] Merger with benefit corporation
        - 5) [8:176.3] Merger into nonprofit corporation
        - 6) [8:177] Disparate treatment within class
          - a) [8:177a] Caution—potential effect of Financial Protection and Innovation Commissioner approval

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

7) [8:177b] “Controlled” merger—disappearing corporation’s common shareholders receive other than common shares

a) [8:177c] Caution—potential effect of Financial Protection and Innovation Commissioner approval

b) [8:177d] Controlling entity has burden of proving fairness

8) [8:177.1] Shares cancelled without any consideration

9) [8:177.2] Preferred shares to receive less than required by articles

(c) [8:177.3] Foreign parent corporation shareholder approval

(d) [8:178] Exceptions—mergers NOT requiring shareholder approval

1) [8:179] Preferred shares unaffected by merger

2) [8:180] Certain “short-form” mergers

3) [8:181] Mergers resulting in limited dilution of voting power

a) [8:182] Measuring dilution

b) [8:183] Limitations

1/ [8:183.1] Articles amendment required

2/ [8:183.2] “Different” shares received

3/ [8:183.3] Disappearing close corporation

(4) [8:184] Amendments to merger agreement

(5) [8:186] Power of boards to abandon merger

(a) [8:187] Compare—contract liability

(6) [8:189] Merger documents filed with Secretary of State

(7) [8:190] Correcting defects in merger documents

(8) [8:190.1] When merger effective

c. [8:191] Effect of merger

(1) [8:192] Transfer of assets

(a) [8:192a] Recording merger certificate to effect realty transfer

(b) [8:192.1] No sales tax

(c) [8:192.2] Local business licenses and permits

1) [8:192.3] “Change of ownership”

2) [8:192.4] “Reevaluation” allowed

3) [8:192.5] Tax reassessments allowed

(d) [8:192.11] Attorney-client privilege

(2) [8:193] Transfer of liabilities

(a) [8:193.1] Franchise tax obligations

(b) [8:194] Punitive damages claims

(3) [8:195] Dissenters' rights

d. [8:196] Compare—“short-form” mergers

(1) [8:196.1] “Upstream” mergers (subsidiary into parent)

(a) [8:197] Wholly-owned subsidiary

1) [8:198] *Resolution or merger plan* adopted…

2) [8:199] Filing with the Secretary of…

(b) [8:201] 90%-owned subsidiary

1) [8:202] The resolution or merger plan…

2) [8:203] The *parent* board's resolution or…

3) [8:204] Along with approval of the…

4) [8:205] A *certificate of ownership* must…

5) [8:205.1] The parent corporation must also…

(2) [8:205.2] “Downstream” mergers (parent into subsidiary)

(a) [8:205.3] Procedure

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) [8:205.4] *Resolution* or *merger plan* adopted…
2) [8:205.5] *Approval* of the merger's principal…
3) [8:205.6] Filing with the Secretary of…
4) [8:205.7] Mailing notice to the subsidiary's…
(b) [8:205.9] Dissenters' rights for subsidiary's minority shareholders
(3) [8:206] Qualification not required
(4) [8:207] Name changes
(5) [8:208] Applicability to foreign corporations
(6) [8:210] Dissenters' rights
e. [8:210.1] Compare—mergers with noncorporate entities ("interspecies" mergers)
(1) [8:210.2] Compliance with laws governing noncorporate entities required
(a) Entity approval requirements
1) [8:210.3] General partnerships
2) [8:210.4] Limited partnerships
3) [8:210.4a] LLCs
4) [8:210.4b] LLC members'/limited partners' unanimous consent to personal liability
5) [8:210.4c] Merger with benefit corporation
(b) [8:210.5] Equal treatment of limited partners or members
(c) [8:210.5a] Shareholder's, partner's or LLC member's postmerger liability
1) [8:210.5b] Special provision re general partners
2) [8:210.5c] Special provision re LLCs
(d) [8:210.6] Dissenters' rights
(2) [8:210.7] Procedure to effect merger
(a) [8:210.8] Merger agreement
1) [8:210.9] Equal treatment for all shares of same class
2) [8:210.10] Execution by corporation
(b) [8:210.11] Approval by board of constituent corporation
(c) [8:210.12] Mergers proposed by insiders
(d) [8:210.13] Approval by shareholders
1) [8:210.14] No exception for mergers resulting in limited dilution
a) [8:210.14a] Compare—two-thirds approval required for SPCs
2) [8:210.14e] Unanimous consent required where shareholders become personally liable
3) [8:210.15] "Controlled" merger—unanimous consent required where common shareholders receive other than common shares or noncorporate equity securities
a) [8:210.16] Exception—Financial Protection and Innovation Commissioner approval
(e) [8:210.17] Amendments to merger agreement; abandonment
(f) [8:210.18] Merger documents filed with Secretary of State
1) [8:210.19] Noncorporate entity as survivor
a) [8:210.19a] Execution of certificate
b) [8:210.19b] Additional information permitted on form
2) [8:210.20] Corporation as surviving entity
3) [8:210.21] Filing fee
(3) [8:210.22] Effect of merger
(4) [8:210.23] Dissenting shareholders' rights
f. [8:210.26] Compare—mergers with *foreign* entities
(1) [8:210.27] Shareholders' rights (California corporation)
(2) [8:210.28] California corporation as survivor
(a) [8:210.29] When merger effective
(3) [8:210.30] Foreign entity as survivor

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [8:210.31] When merger effective
1) [8:210.32] Exception—delayed California filing
(4) [8:210.33] Effect on disappearing foreign entities
(a) [8:210.34] Exception—delayed California filing
g. [8:211] Tax consequences ("A reorganizations")
(1) [8:212] Straight merger
(a) [8:213] Basis carryovers
(b) [8:214] Taxability of "boot"
1) [8:214.1] "Postreorganization" approach
2) [8:214.2] "Nonqualified preferred stock" as "boot"
(c) [8:215] Continuity of interest requirement
1) [8:216] Must be stock or stock rights
a) [8:216.1] Caution—"nonqualified preferred" probably not acceptable
b) [8:217] Debt
c) [8:218] Stock exchanged for combination of stock, debt and/or cash
d) [8:218.1] Compare—debt exchanged for debt
e) [8:218.2] Compare—debt exchanged for stock
2) [8:218.5] Sale of interest
(d) [8:218.10] Continuity of business requirement
1) [8:218.11] Merger coupled with partial asset sale
(2) [8:219] Triangular mergers
(a) [8:219.1] Merger into noncorporate entity permitted
(3) [8:220] Reverse triangular mergers
(4) [8:222.1] Mergers of 80%-owned subsidiaries
(5) [8:223] Advantage of merger ("A reorganization") over stock-for-stock exchange ("B reorganization")
(a) [8:224] Example
(b) [8:225] Further example
h. Securities laws considerations
(1) [8:226] Federal securities laws
(a) [8:227] Proxy rules
(b) [8:228] Registration requirements
(c) [8:229] Antifraud rules
(2) [8:230] California Corporate Securities Law
(a) [8:231] "Nonresidents" exemption
1) [8:232] Distinguish—other recapitalization exemptions inapplicable
(b) [8:232.1] "Limited exchange transaction" exemption
1) [8:232.4] Notice of transaction
a) [8:232.5] Where to file
(c) [8:232.10] Exchanges approved by bankruptcy court
(d) [8:233] Commissioner's standards re granting permit
(e) [8:234] Soliciting shareholder approval
4. [8:235] Exchange Reorganizations (Stock-for-Stock)
a. Procedure
(1) [8:236] Tender offer by acquiring corporation
(a) [8:237] Terms
(2) [8:237.1] Offer made by insider
(a) [8:237.2] Who is an "interested party"
1) [8:237.3] Exception—corporations with fewer than 100 shareholders
2) [8:237.4] Exception—exchange qualified by permit

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- (b) [8:237.5] Independent fairness opinion
  - 1) [8:237.6] Delivery of opinion
  - 2) [8:237.6a] Opining person's qualifications
- (c) [8:237.7] Competing offers
  - 1) [8:237.8] Insider proposal delayed pending shareholder action on competing offer
  - 2) [8:237.8a] Improving insider offer
- (3) [8:238] Shareholder approval by acquiring corporation
  - (a) [8:238.1] Measuring shareholder approval
    - 1) [8:238.1a] Foreign corporation shareholder approval
  - (b) [8:238.2] Before or after board approval
  - (c) [8:238.3] Exception—share exchanges involving SPCs (two-thirds approval required)
  - (d) [8:238.4] Exception—share exchanges involving benefit corporations (two-thirds approval required)
  - (e) [8:239] Exceptions—share exchanges NOT requiring shareholder approval
    - 1) [8:240] Preferred shares unaffected by share exchange
    - 2) [8:241] Exchanges resulting in limited dilution of voting power
      - a) [8:241.1] Limitation—articles amendment required
      - b) [8:241.2] Limitation—disappearing close corporation
  - (f) [8:242] Dissenters' rights
- (4) [8:243] Abandonment
- b. [8:244] Tax treatment (“B reorganization”)
  - (1) [8:245] Continuity of interest
  - (2) [8:246] Solely for voting stock of acquiring corporation
    - (a) [8:246a] Caution—“voting stock” excludes “nonqualified preferred”
    - (b) [8:246b] Exception—concomitant exchange of bonds
    - (c) [8:246.1] Exception—payment for fractional shares; target corporation's expenses
  - (3) [8:247] At least 80% control acquired
  - (4) [8:248] Compare—merger requirements
- c. Securities laws considerations
  - (1) [8:249] Federal securities laws
    - (a) [8:250] Registration requirements
    - (b) [8:251] Proxy rules
    - (c) [8:252] Tender offer rules
    - (d) [8:253] Antifraud rules
  - (2) [8:254] California Corporate Securities Law
    - (a) [8:254.1] Limited offering exemption (§ 25102(f)) applicable
    - (b) [8:255] Exemption—“forced sale” exchange where less than 25% of target held by California residents
      - 1) [8:256] Less than 25% of the…
      - 2) [8:257] The exchange is subject to…
      - 3) [8:258] Any shareholder of the target…
- 5. [8:259] Sale-of-Assets Reorganizations
  - a. [8:261] All or “substantially all” assets
  - b. [8:262] Procedure
    - (1) [8:263] Approval by both boards
    - (2) [8:264] Approval by shareholders of both corporations
      - (a) [8:264.1] Caution—two-thirds approval required in certain SPC reorganizations
      - (b) [8:264.2] Measuring shareholder approval
        - 1) [8:264.3] Foreign corporation shareholder approval

(c) [8:264.4] Before or after board approval
(d) [8:265] Exception as to unaffected preferred shareholders
1) [8:265.1] Preferred shares to receive less than required by articles
(e) [8:266] Exception where limited dilution of voting power
(f) [8:270] 90% approval required if corporations under common control
1) Exceptions
a) [8:271] Seller given equity in purchaser
1/ [8:271.1] Added condition re SPCs
b) [8:271.2] Sale approved by Commissioner
2) [8:272] Compare—alternatives available
(g) [8:273] Dissenters' rights
(3) [8:273.1] Sale-of-assets reorganization proposed by insider
(a) [8:273.2] Who is an “interested party”
1) [8:273.3] Exception—corporations with fewer than 100 shareholders
2) [8:273.4] Exception—exchange qualified by permit
(b) [8:273.5] Independent fairness opinion
(c) [8:273.6] Competing offers
(4) [8:274] Abandonment
(5) [8:275] Documentation
(6) [8:275.1] Seller corporation's liabilities imposed on acquiring corporation (“de facto mergers”)
(a) [8:275.2] Compare—product liability claims
(7) [8:275.3] Special employee notice requirements (layoffs, plant closures, relocations)
c. [8:276] Tax treatment (“C reorganization”)
(1) [8:277] Substantially all assets sold
(a) [8:278] IRS guidelines
(b) [8:278.1] Applies where portion of assets sold for cash
(2) [8:279] Exchange for purchaser's voting stock
(a) [8:281] Assumption of liabilities disregarded
(b) [8:281.1] Asset sale to existing shareholder permitted
(c) [8:282] “Boot” permitted if at least 80% of assets acquired for stock
(3) [8:282.1] Transferor corporation must distribute stock
(4) [8:282.2] No gain or loss recognized by corporation
(a) [8:282.3] Exception for “boot” and other assets
d. [8:283] Securities laws considerations
(1) [8:284] Federal securities laws
(a) [8:285] Proxy rules
(b) [8:286] Registration requirements
(c) [8:287] Antifraud rules
(2) [8:288] California Corporate Securities Law
(a) [8:289] Exemptions
1) [8:289.1] “Nonresident shareholders exemption”
2) [8:289.2] “Limited exchange transaction exemption”
a) [8:289.4] Compare—less than all (or substantially all) assets exchanged for stock
3) [8:289.5] Exchanges approved by bankruptcy court
(b) [8:291] Qualification procedure
6. [8:292] Dissenters' Rights
a. [8:293] Purpose
b. [8:293.1] Not applicable in reorganization, merger or conversion where articles contain payment amount
c. Transactions triggering dissenters' rights

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- (1) [8:293.2] Reorganizations
  - (a) [8:293.3] Compare—SPCs
- (2) [8:293.4] Conversions to noncorporate entity
- (3) [8:293.5] Change of status
  - (a) [8:293.6] Comment
- (4) [8:293.7] *Not* recapitalizations

d. [8:294] Shares eligible for appraisal rights
- (1) [8:295] Shares outstanding
  - (a) [8:296] Compare—unexercised stock rights
- (2) [8:297] Shares NOT readily marketable
  - (a) [8:298] Shares deemed readily marketable
    - 1) [8:302.1] Elimination of 5% requirement
- (3) [8:303] Shares entitled to vote on reorganization
  - (a) [8:304] Shares ineligible because not entitled to vote
    - 1) [8:305] Preferred shares unaffected by reorganization
    - 2) [8:306] Shares whose voting power not significantly diluted
      - a) [8:307] Exception—statutory close corporation
      - b) [8:307.1] Exception—merger with surviving SPC and disappearing nonSPC
  - (b) [8:308] Compare—short-form mergers
  - (c) [8:309] Compare—shareholder approval required under other provisions
    - 1) [8:310] Example
    - 2) [8:311] Rationale
- (4) [8:312] Shares not voted in favor of reorganization
  - (a) [8:313] Compare—listed shares must be voted against
  - (b) [8:314] Comment
- (5) [8:315] Shares qualified procedurally

e. [8:316] Procedure for exercising appraisal rights
- (1) [8:321] Shareholder demand upon corporation
  - (a) [8:322] Time limit for shareholder demand
    - 1) [8:325] When prior notice required from corporation
    - 2) [8:325.1] Contents of corporation's notice
    - 3) [8:326] Notice as irrevocable offer
  - (b) [8:327] Contents of shareholder demand
    - 1) [8:328] Demand as irrevocable offer
- (2) [8:329] Delivering certificate for endorsement
  - (a) [8:330] Time limit for delivery
  - (b) [8:331] Endorsement by corporation
- (3) [8:332] Obtaining payment where value agreed upon
  - (a) [8:333] Plus interest
- (4) [8:334] Action to enforce payment where no agreement
  - (a) [8:335] Time limit for commencing action
  - (b) [8:336] Joinder and consolidation of actions
  - (c) [8:337] Issues to be tried
    - 1) [8:338] Valuation date
  - (d) [8:340] Procedure for determining value (appraisal process)
    - 1) [8:341] Report by appraisers
    - 2) [8:342] Court may accept or reject
      - a) [8:342.1] “Net book value” method may be proper
    - 3) [8:343] Determination by court

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

4) [8:344] Other evidence of value
(e) [8:345] Judgment
1) [8:346] Interest
2) [8:347] Costs
f. [8:350] Effect of lack of lawful source for payment
g. [8:351] Effect of dividends paid
h. [8:352] Termination of dissenting share status
i. [8:358] Appraisal rights exclusive remedy
(1) [8:361] Exception—action to enforce special articles provision
(a) [8:361.1] Limitation—when merger or sale-of-assets agreement controls
(2) [8:362] Exception—action to test validity of shareholder approval
(a) [8:363] Application
(b) [8:364] Suspends other proceedings
(3) [8:365] Exception—action to set aside reorganization not at "arm's length"
(a) [8:366] Either as bar to other; no damages action
(b) [8:367] Burden of proof on controlling party
1) [8:367.1] Compliance with special procedures for "controlling person" reorganizations
(c) [8:368] Relief available
(4) [8:370] Compare—action under federal securities laws
(a) [8:371] Anti-fraud rules
(b) [8:372] Proxy rules
1) [8:372.1] Causal nexus required between fraud and injury
j. [8:372.2] Waiver?
7. [8:373] Divisive Reorganizations
a. [8:374] Forms of reorganization
(1) [8:375] Spin-off
(a) [8:376] Example
(b) Procedural considerations
1) [8:377] Formation
2) [8:378] Distributions limitations
(c) Securities law considerations
1) [8:379] Federal law
a) [8:380] Potential for abuse
b) [8:381] Current SEC position
c) [8:381.1] "Valid business purpose"
d) [8:381.3] Spun-off securities ordinarily not "restricted"
e) [8:382] Spin-off disclosure statements
2) [8:383] California law
(2) [8:385] Split-offs
(a) [8:386] Example
(b) [8:387] Procedural considerations
1) [8:388] Formation
2) [8:389] Distributions limitations
(c) [8:390] Securities law considerations
1) [8:391] Federal law
2) [8:392] California law
(3) [8:394] Split ups
(a) [8:395] Example
(b) Procedural considerations

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) [8:396] Formation
2) [8:397] Shareholder approval required
3) [8:398] Liquidation distribution
(c) [8:399] Securities law considerations
b. [8:401] Tax treatment ("D reorganization")
(1) [8:402] Requirements
(a) [8:403] "Device" rule
1) [8:404] Example
(b) [8:405] Distribution of control
(c) [8:408] Five-year active business
1) [8:409] "Passive" business distinguished
2) [8:409.1] Spin-off of business acquired during five-year period ("expansion doctrine")
(2) [8:410] Gain or loss computations
(a) [8:411] Carryover basis
(b) [8:412] Taxability of "boot"
1) [8:412a] "Nonqualified preferred stock" as "boot"
(c) [8:412.1] Exception—corporate gain recognized upon certain stock distributions/sales
(d) [8:413] Compare—nonqualifying transactions
(3) [8:413.1] California property tax reassessment
(4) [8:413.2] Application of documentary transfer tax
8. [8:414] Other Nontaxable Reorganizations

1. [8:118] **Introduction:** The acquisition of a corporate business can be structured in many ways, each involving different corporate, tax and securities law requirements with potentially differing consequences to the buyer and seller. Counsel for both buyer and seller must carefully analyze various factors in advising their clients on the most suitable acquisition method.

• [8:118a] **Compare—acquisition of noncorporate entities:** Corporations are free, of course, to acquire businesses that operate in other than corporate form (e.g., limited partnerships or LLCs) and may even *merge* with noncorporate entities (*see ¶ 8:210.1 ff.*). However, except in limited circumstances (*¶ 8:219.1*), acquisitions of noncorporate entities or their assets do not have the potential for tax-free treatment that acquisitions of corporate businesses enjoy under IRC § 368(a)(1). Hence, acquisitions involving noncorporate entities are discussed only briefly in the paragraphs that follow. For a more detailed discussion of mergers involving noncorporate entities, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG).

a. [8:118.1] **Acquisition methods:** There are three basic methods by which a corporation can acquire another corporate business (see *Superbrace, Inc. v. Tidwell* (2004) 124 CA4th 388, 405, 21 CR3d 404, 416 (citing text)):

(1) [8:118.2] **Stock purchase:** One corporation can acquire another by obtaining the other corporation's stock from the owners. The acquiring corporation becomes the *parent corporation* and the acquired corporate entity continues intact as its *subsidiary*.

(a) [8:118.3] **Stock-for-stock exchange:** Where the acquiring corporation obtains another corporation's stock by issuing its own (or its parent's) stock or other equity securities in exchange for a controlling interest in the target corporation, the acquisition is considered a "stock-for-stock exchange reorganization" and is subject to special corporate, tax, and securities law treatment (*see ¶ 8:235 ff.*).

(2) [8:118.4] **Asset purchase:** A corporation's business and assets can be acquired directly by purchase, leaving its share ownership unchanged. The selling corporation's shareholders must approve the sale (*see ¶ 8:581 ff.*). Typically, the selling corporation will dissolve and liquidate after the sale, distributing to its shareholders its remaining assets—i.e., the consideration received in the sale (*see ¶ 8:751 ff.*).

(a) [8:118.5] **Assets purchased in exchange for stock:** If the acquiring corporation acquires another corporation's business and assets partly or wholly in exchange for its (or its parent's) stock or certain debt securities, the acquisition is considered a "sale-of-assets reorganization" and is subject to special corporate, tax and securities law treatment (*see ¶ 8:259*).

(3) [8:118.6] **Merger:** A statutory merger, whereby one corporation is absorbed into another, is the third acquisition method. Where the acquired corporation is merged directly into the acquiring corporation, the surviving corporation receives all

of the disappearing corporation's business, assets and liabilities by operation of law. Unless cashed out, the disappearing corporation's shareholders become shareholders of the surviving corporation. A merger acquisition is a “reorganization” subject to special corporate, tax and securities law treatment (*see ¶ 8:161 ff.*).

b. Considerations affecting choice of acquisition method

(1) Corporate law considerations

(a) [8:118.7] **Shareholder approval requirements:** Depending upon the acquisition method, the shareholders (as well as the directors) of one or both combining corporations must approve the transaction.

Generally, approval of the outstanding shares of each class of *both* corporations must be obtained for a merger (*¶ 8:173*) or “stock-for-assets reorganization” (*¶ 8:264*). In contrast, only the *seller's* outstanding shares need approve a “stock-for-stock exchange reorganization” (*¶ 8:238*) or an acquisition of all, or substantially all, the assets of the selling corporation that is not a “reorganization” (i.e., a sale of assets; *¶ 8:589*).

1) [8:118.8] **Dissenter's rights:** Further, shareholders who have the right to vote on the transaction may have “dissenter's rights,” entitling them to cash payment of their shares' appraised value (*see ¶ 8:292 ff.*).

(b) [8:118.9] **Liabilities acquired:** The acquiring corporation in a merger transaction directly assumes *all* the acquired corporation's liabilities, known and unknown, actual or contingent (¶ 8:193 ff.).

In a triangular merger or “stock-for-stock exchange” where the acquired corporation becomes a subsidiary of the acquiring corporation, the liabilities of the acquired corporation become liabilities of the survivor subsidiary corporation but not liabilities of the parent acquiring corporation. However, the acquiring corporation may be responsible for some or all of the seller's liabilities by agreement (e.g., to obtain the consent of third-party creditors of the acquired corporation to the merger or acquisition) or under the doctrine of “de facto merger” (¶ 8:275.1), “mere continuation” (¶ 8:656 ff.) or “successor liability” (¶ 8:663 ff.).

(c) [8:118.10] **Contract restrictions on transferability of assets:** It is important to determine whether either corporation is a party to an outstanding agreement limiting the ability to effect any sale, acquisition or combination. Such limitations may apply to some acquisition methods, but not to others.

1) [8:118.11] **Using merger or stock acquisition to bypass transfer restrictions:** For example, the acquired corporation may have advantageous leases, contracts, loans, etc., which are nontransferable or transferable only after securing difficult consents. Such valuable rights *might* be retained notwithstanding the transfer restriction where the transaction is cast as a merger, but only if the restriction does not apply to transfers “by operation of law.”

Alternatively, the acquiror could purchase the acquired corporation's stock, or could structure the transaction as a reverse triangular merger (¶ 8:166), so that the acquired corporation continues in existence as a wholly-owned subsidiary of the acquiror without transferring any assets. (But this will not bypass a transfer restriction that applies to such a change in stock ownership.)

(d) [8:118.12] **Bulk sale restrictions:** The bulk sales law will apply to the bulk sale of inventories, e.g., in a sale of assets transaction (*see ¶ 4:511 ff.*).

(e) [8:118.13] **Antitrust restrictions:** Although beyond the scope of this Practice Guide, application of the federal and state antitrust laws must be considered in any corporate acquisition or combination. [See 15 USC §§ 1, 2, 18; Bus. & Prof.C. § 16700 et seq.; see also *California v. American Stores Co.* (1990) 495 US 271, 296, 110 S.Ct. 1853, 1867—Clayton Act authorizes *private* divestiture remedy for anticompetitive mergers] However, it is unlikely that the acquisition method chosen will have any effect on the application of these restraints on anticompetitive combinations.

(f) [8:118.14] **Covenants not to compete:** The acquiring corporation may wish the acquired corporation's employees, officers, directors and/or shareholders to enter into a covenant not to compete with it. California law generally voids covenants not to compete because they are contracts in restraint of trade (Bus. & Prof.C. §§ 16600 (amended Stats. 2023, Ch. 828; eff. 1/1/24), 16600.1 (added Stats. 2023, Ch. 828; eff. 1/1/24), 16600.5 (added Stats. 2023, Ch. 828; eff. 1/1/24), ¶ 6:401.1 ff.). However, such covenants are valid where given by:

• The seller of a business, including its goodwill;

• A “substantial” shareholder selling *all* of the shareholder's shares (*see ¶ 6:401.2 ff.*);

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Any shareholder of a corporation which sells all or substantially all of its operating assets (or the assets of any of its divisions or subsidiaries) together with the goodwill; or

• Any shareholder of a corporation that sells all of its ownership interest in a subsidiary. [Bus. & Prof.C. § 16601]

1) [8:118.14a] **Geographic/temporal limits:** A covenant not to compete will be enforced only to prevent competing activities (i.e., "carrying on a similar business") within a specified geographic area in which the sold business was conducted, and only for so long as the buyer or its successors carry on a like business therein. [Bus. & Prof.C. § 16601; see *Alliant Ins. Services, Inc. v. Gaddy* (2008) 159 CA4th 1292, 1301, 72 CR3d 259, 266-267; *Fleming v. Ray-Suzuki, Inc.* (1990) 225 CA3d 574, 583-584, 275 CR 150, 155-156—covenant not to compete in same type of mail order business "in the United States" enforceable because represented area of existing goodwill sold with business]

2) [8:118.14b] **Scope of covenant limited to protection of purchased business:** The purpose of Bus. & Prof.C. § 16601 is to protect the value of the *business acquired by the buyer*. A noncompete covenant that goes beyond that scope—e.g., shielding the buyer from competition unrelated to the purchased business—is unenforceable. [*Strategix, Ltd. v. Infocrossing West, Inc.* (2006) 142 CA4th 1068, 1072-1073, 48 CR3d 614, 616; *Monogram Indus., Inc. v. Sar Indus., Inc.* (1976) 64 CA3d 692, 701, 134 CR 714, 720]

• [8:118.14c] A covenant not to solicit the acquired business' employees and customers is permissible … because it prevents the seller from eroding the very goodwill it sold. On the other hand, a covenant barring the seller from soliciting *all* employees and customers of the seller, including those who were not employees or customers of the acquired business, would give the buyer unduly broad protection against competition. [*Strategix, Ltd. v. Infocrossing West, Inc.* (2006) 142 CA4th 1068, 1073-1074, 48 CR3d 614, 617]

• [8:118.14d] An employment agreement's noncompetition clause, which barred the employee from competing with the employer for one year following termination of employment, was unenforceable even though the employment agreement was executed as part of a sale to the employer of what was then the employee's business. The sale was consummated by way of an asset purchase agreement that contained its own covenant barring the employee/owner from competing for three years following the purchase. The covenant served its purpose of protecting the purchaser and had been fully performed when the employee/owner terminated his employment under the employment agreement. (Additionally, the employment agreement clause was overbroad, because it contained a provision barring the employee/owner from soliciting the employer's *potential* customers.) [*Fillpoint, LLC v. Maas* (2012) 208 CA4th 1170, 1182-1183, 146 CR3d 194, 203-204]

3) [8:118.14e] **Limitation—post-employment noncompete covenants:** Other than as permitted by Bus. & Prof.C. § 16600 et seq., employer prohibitions on the solicitation of customers or employees after the termination of employment are unenforceable. [See *Edwards v. Arthur Andersen LLP* (2008) 44 C4th 937, 945-948, 81 CR3d 282, 288-290 (customers); *AMN Healthcare, Inc. v. Aya Healthcare Services, Inc.* (2018) 28 CA5th 923, 935-939, 239 CR3d 577, 587-590 (employees); *and discussion at* ¶ 6:401.1 ff.]

4) [8:118.14f] **Tax treatment—payments amortizable:** Payments made under a covenant not to compete are amortizable over a 15-year period by the acquiring corporation. The payments are not otherwise deductible or depreciable. [IRC § 197; see Treas.Reg. § 1.197-1T (temp.); also see *Frontier Chevrolet Co. v. Commr.* (9th Cir. 2003) 329 F3d 1131, 1134-1135—redemption of majority shareholder's stock to give minority shareholder complete ownership treated as IRC § 197 "acquisition" amortizable over 15 years (not over 5-year contract term)]

(g) [8:118.15] **Special employee notice requirements (layoffs, plant closures, relocations):** If an acquisition results in a *mass layoff* or a *plant closure or relocation* affecting at least 50 employees, special notice requirements may need to be satisfied pursuant to the federal Worker Adjustment and Retraining Notification Act ("WARN Act," 29 USC §§ 2101-2109) and its California counterpart (Lab.C. § 1400 et seq.). *See discussion at ¶ 8:1041 ff.*

(2) [8:118.16] **Securities law considerations:** Application of the federal and California securities laws must be considered where the acquiror offers its (or its parent's) shares or other securities for the assets or stock being acquired. The securities law requirements vary depending upon which acquisition method is employed (*see ¶ 8:226 ff., 8:283 ff.*). The only acquisition method that clearly avoids any securities law complication is an all-cash asset acquisition (*¶ 8:711*).

(3) [8:118.17] **Tax considerations:** The selling corporation or shareholders will usually want the transaction to be "tax-free" (i.e., structured to avoid presently taxable gains on the sale). On the other hand, the acquiror may want the acquisition

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

to be taxable to the sellers in order to obtain a "step-up" in basis of the assets acquired. The transaction's form will determine whether it is taxable or nontaxable, or trigger sales and property taxes.

(a) [8:118.18] **Tax-free acquisitions:** An acquisition is taxable unless it qualifies as one of the *three* tax-free "reorganizations" described in IRC § 368—i.e., an "A" reorganization applicable to statutory mergers (*¶ 8:211 ff.*); a "B" reorganization applicable to "stock-for-stock exchanges" (*¶ 8:244 ff.*); or a "C" reorganization applicable to "stock-for-assets exchanges" (*¶ 8:276 ff.*). The requirements for tax-free treatment vary significantly, depending upon which acquisition method is employed.

(b) [8:118.19] **Sales taxes:** Sales taxes may be imposed on a sale of assets (*¶ 8:703*), but not on a merger or stock acquisition.

(c) [8:118.20] **Property tax reassessments:** A real property transfer will generally trigger revaluation for property tax purposes. Even a transfer "by operation of law" (e.g., a merger) will result in revaluation if the property-owning corporation disappears. [See *Sav-on Drugs, Inc. v. County of Orange* (1987) 190 CA3d 1611, 1621, 236 CR 100, 105]

Likewise, even though the property-owning corporation *remains in existence*, a change in its ownership or ownership of its parent may trigger a reassessment. For example, a subsidiary corporation's real property must be revalued when its parent's *controlling* stock is acquired in a merger reorganization. [*Title Ins. & Trust Co. v. County of Riverside* (1989) 48 C3d 84, 92-94, 255 CR 670, 674-676—acquisition of parent's stock in merger constituted "change of ownership" of subsidiary's real property]

In other words, a "change of ownership" triggering reassessment occurs any time there is a change in the corporate *entity* that *owns* the real property *or* in its controlling shareholder(s). [See *Twentieth Century Fox Film Corp. v. County of Los Angeles* (1990) 223 CA3d 1158, 1163-1164, 273 CR 76, 79; *Kraft, Inc. v. County of Orange* (1990) 219 CA3d 1104, 1108-1109, 268 CR 643, 646—corporation's acquisition of property-owning corporation in merger triggered reassessment even though acquired corporation's shareholders became majority shareholders in new parent corporation; *and ¶ 2:177.8 ff.*]

(d) [8:118.20a] **Application of documentary transfer tax:** A change in the beneficial ownership of an entity owning real property may also trigger the imposition of a documentary transfer tax under the Documentary Transfer Tax Act (Rev. & Tax.C. § 11911 et seq.). A documentary transfer tax is payable not only on the recording of a written instrument conveying an interest in real property, but also when a written instrument conveys a majority interest in a legal entity that owns, directly or indirectly, the real property. This is so even where the instrument *does not directly reference the real property and is not recorded*. To conclude otherwise would elevate form over substance and conflict with the purpose of the Documentary Transfer Tax Act. [Rev. & Tax.C. § 11911; *926 North Ardmore Ave. LLC v. County of Los Angeles* (2017) 3 C5th 319, 329-338, 219 CR3d 695, 702-709; *see ¶ 2:177.10*]

c. [8:118.21] **Accounting treatment:** An acquisition is accounted for as a "purchase." The acquirer must allocate the fair market value of the consideration paid for the acquired assets in accordance with their fair market values. As a result, the assets are brought onto the acquirer's balance sheet at their fair market ("stepped-up") values, not the former ("carryover") values shown on the acquired corporation's books. [See Financial Accounting Standards Board, Accounting Standards Codification Topic 805-20-25 ("Business Combinations—Identifiable Assets and Liabilities, and Any Noncontrolling Interest—Recognition")]

(1) [8:118.22] **Goodwill:** Where the total price *exceeds* the fair market value of the acquired assets, the difference is "goodwill," which must be *amortized* against the acquirer's earnings for financial accounting purposes. [See Financial Accounting Standards Board, Accounting Standards Codification Topic 805-30 ("Business Combinations—Goodwill or Gain from Bargain Purchase, Including Consideration Transferred")]

(For tax purposes, "goodwill" is not deductible but must be amortized over a 15-year period. See IRC § 197; Treas.Reg. § 1.197-1T (temp.).)

(2) [8:118.23] **"Pooling of interests" method abolished:** The "pooling of interests" method permitted an acquiring corporation, in certain stock-for-stock acquisitions, to combine the acquired corporation's assets and liabilities (including current and retained earnings) with its own at their former ("carryover") value shown on the acquired corporation's books. This "pooling" approach precluded the creation of any "goodwill."

However, "pooling of interests" is no longer permitted in combinations of "for-profit" corporations. [Financial Accounting Standards Board, Accounting Standards Codification Topic 805-30, supra]

[8:118.24 - 8:118.25] ***Reserved.***

d. [8:118.26] **Corporate "reorganizations":** Any change in the corporate structure that significantly alters creditor or shareholder interests may be considered a "reorganization." This includes purely *internal* changes entirely within an existing corporation (i.e., recapitalizations); acquisitions or *combinations* involving more than one corporation (e.g., merger or other acquisitive reorganizations); and *divisions* of the corporation into new entities.

➪ [8:118.27] ***CAUTION—DUTY TO DISCLOSE*****:** Management and other "insiders" have a duty to disclose *pending* reorganization plans and negotiations where they constitute "material" investor information under the securities law anti-fraud rules. *See discussion at ¶ 6:370.1*.

[8:118.28 - 8:118.30] ***Reserved.***

e. [8:118.31] **Acquisition and reorganization expenses generally** ***not deductible:*** Expenses incurred in connection with corporate acquisitions, reorganizations and recapitalizations (e.g., legal, accounting and investment banking fees) are *not* deductible as "ordinary and necessary" business expenses (IRC § 162(a)) if the benefits of the transaction extend *beyond the year in which it occurred*. Such expenses are more akin to *capital expenditures*, and thus must be amortized and depreciated over the useful life of the asset to which they pertain or, if no specific asset or useful life can be ascertained, deducted upon final disposition (IRC § 167). [*INDOPCO, Inc. v. Commr.* (1992) 503 US 79, 88-90, 112 S.Ct. 1039, 1045-1046; see Treas.Reg. § 1.263(a)-5]

(1) Application

• [8:118.31a] Thus, expenses incurred by a target corporation in a friendly takeover were *not* deductible under § 162(a). [*INDOPCO, Inc. v. Commr.* (1992) 503 US 79, 88-90, 112 S.Ct. 1039, 1045-1046]

[8:118.31b - 8:118.31d] ***Reserved.***

• [8:118.31e] But fees paid to *resist a hostile takeover* were *deductible*—even where the takeover was eventually accepted. [*A.E. Staley Mfg. Co. & Subsidiaries v. Commr.* (7th Cir. 1997) 119 F3d 482, 487-493; *Matter of Federated Dept. Stores, Inc.* (SD OH 1994) 171 BR 603, 608-610; compare *Dana Corp. v. United States* (Fed. Cir. 1999) 174 F3d 1344, 1350-1352—annual retainer paid to law firm to secure its availability in case of hostile takeover not deductible where retainer was applied to legal services rendered in connection with corporate client's acquisition of another company (capital expenditure)]

• [8:118.31f] A $65 million merger termination fee paid to allow merger with another suitor did not produce significant benefits in future tax years. Hence, it was deductible under IRC § 162(a) (and IRC § 165—loss not compensated by insurance or otherwise). [*Santa Fe Pac. Gold Co. & Subsidiaries v. Commr*. (2009) 132 TC 240, 271-279; but see IRS Memo Rel.No. 20163701F (Field Attorney Advice) (cannot be used or cited as precedent)—"break fee" paid on termination of merger agreement was capital rather than ordinary loss]

• [8:118.31g] Corporate officers' salaries were fully deductible as "ordinary and necessary" expenses notwithstanding that the officers spent a portion of their time on a friendly takeover: The officers' salaries originated from their employment relationship with the corporation and were only *indirectly related to the takeover*. [*Wells Fargo & Co. & Subsidiaries v. Commr.* (8th Cir. 2000) 224 F3d 874, 886-888]

(2) [8:118.32] **Compare—investigation expenses:** Up to $5,000 of expenses made in connection with *investigating* the acquisition of an existing trade or business may be deducted by the corporation in the year in which the trade or business is acquired. The $5,000 maximum is reduced by the amount by which the investigation expenses exceed $50,000, and any remaining investigation expenses can be deducted ratably over a 180-month period. (In contrast, expenses occurring after a specific company is targeted and the decision to acquire is made must be amortized and depreciated as *capital expenditures*; *see ¶ 8:118.31*.) [IRC § 195; see Rev.Rul. 99-23, 1999-1 CB 998 (predating 2004 amendment of IRC § 195); also see Treas.Reg. § 1.195-1; *Wells Fargo & Co. & Subsidiaries v. Commr.* (8th Cir. 2000) 224 F3d 874, 888-889]

If the acquired business is completely disposed of before the end of the 180-month period, any remaining expenses may be deducted as a loss to the extent allowed under IRC § 165. [IRC § 195(b)(2)]

(3) [8:118.33] **Compare—"success-based fee":** A fee contingent upon successful closing of the transaction (e.g., investment banker's fee) is *presumed* to facilitate the transaction, and hence must be capitalized rather than deducted. However, the corporation may *rebut* the presumption by maintaining sufficient documentation to establish that a portion of the fee is allocable to activities that do *not* facilitate the transaction. [Treas.Reg. § 1.263(a)-5(a), (f)]

(a) [8:118.34] **70%/30% "safe harbor" allocation:** Alternatively, the corporation may elect a "safe harbor" by treating 70% of the success-based fee as *not* facilitating the transaction (deductible) and the remaining 30% as facilitating the transaction (capitalized). The election is made by providing an attachment to the corporation's federal income tax return for the taxable year the success-based fee is paid or incurred, stating that the corporation is electing the safe harbor, identifying the transaction, and stating the success-based fee amounts that are deducted and capitalized. [Rev.Proc. 2011-29, 2011-18 IRB 746]

(b) [8:118.35] **"Milestone payment":** A "milestone payment" is a nonrefundable fee creditable against a "success-based fee" and contingent on an event occurring *in the course* of the transaction (e.g., execution of letter of intent or exclusivity agreement, or board of directors' approval of transaction). Because a milestone payment is not contingent upon *closing* of the transaction, the IRS initially required that the payment be capitalized. However, the IRS' current position is that it will not challenge a corporation's treatment of 70% of a milestone payment as falling within the elective safe harbor (¶ 8:118.34) if deducted on the corporation's tax return for the year in which the payment was incurred (and where the transaction closed in that year, if the corporation made the election with respect to the success-based fee). [See Directive LB&I-04-0413-002 (4/29/13) 2013 WL 9905569 (noting the Directive is not an official pronouncement of law and cannot be used, cited or relied upon); Updated Directive LB&I-04-0114-001 (1/27/14) 2014 WL 6605829 (same)]

The IRS Large Business and International (LB&I) Division is responsible for tax administration activities for domestic and foreign businesses with a United States tax reporting requirement and assets equal to or exceeding $10 million, as well as the Global High Wealth and International Individual Compliance programs. In 2019, the LB&I Division announced a practice unit (which provides IRS staff with explanations of general tax concepts) on the allocation of success-based fees in a covered transaction. [See IRS, "Allocation of Success-Based Fees in a Covered Transaction" (June 13, 2019), available at *www.irs.gov*]

2. [8:119] **Recapitalizations:** In broad terms, any purely internal reshuffling of the capital structure of an existing corporation is a "recapitalization." Normally, it results from an agreement between the corporation and some or all of its shareholders or creditors, whereby outstanding securities or debt are *exchanged* for other debt or securities—all within the framework of a single, existing corporation. [See *Helvering v. Southwest Consolidated Corp.* (1942) 315 US 194, 202-203, 62 S.Ct. 546, 551]

a. [8:120] **Procedure:** The board of directors simply adopts a resolution whereby some or all of the existing shareholders or creditors are to be offered "new" securities for "old." The issuance and exchange of securities effects the recapitalization.

(1) [8:121] **Shareholder approval:** Shareholders to whom the exchange is offered must, of course, accept or approve the offer. But generally there is no need for other shareholders to approve (any more than for other share issuances).

[8:122] The rule is otherwise, however, where the recapitalization requires *amendment of the articles*; e.g., to increase authorized capital, or to create a class of securities having the rights or preferences agreed upon. In such cases, the rules and procedures on amending articles (¶ *8:48 ff.*), including shareholder approval, are an essential step in the recapitalization.

(2) [8:123] **No dissenters' rights:** Since the reshuffling of capital structure is purely internal, shareholders disagreeing with the recapitalization have no right to be cashed out (as they may have in mergers and other acquisitive reorganizations; *see* ¶ *8:293.7*).

b. [8:124] **Tax treatment:** A "recapitalization" is one of the seven forms of corporate reorganizations recognized in the Internal Revenue Code (see IRC § 368(a)(1)(E)). The term is not defined by the Code. Rather, whether a particular exchange of securities is a "recapitalization" for tax purposes is determined by whether it results in a *substantial change* in the investor's interest in the corporation.

(1) [8:125] **Tax-free exchange generally:** If stock is exchanged *solely* for other stock in the same corporation (or if securities are exchanged solely for other securities having no greater face amount), then there is a substantial *continuity* of investment interest. Hence, such an exchange is generally tax-free. [IRC § 354(a): "No gain or loss shall be recognized if stock or securities in a corporation … are exchanged solely for stock or securities in such corporation …"]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

The security holder's tax basis in the "old" stock or securities is carried over and becomes the security holder's basis in the "new" stock or securities. [IRC § 358(a)(1)]

(2) [8:126] **Limitations:** But an exchange is not tax-free where the investor's interest is substantially *different* after the exchange; particularly:

• [8:127] **Exchanges having effect of dividends:** An exchange of securities which results in *disparate treatment* among security holders of the same class (e.g., giving some shareholders preferential rights to income over others) is treated as a taxable dividend to the favored shareholders (*see* *¶ 7:199*).

• [8:128] **Exchanges having effect of redemptions:** Where debt securities are issued in exchange for outstanding shares, the transaction is treated as a repurchase or redemption of the shares, and is taxed accordingly (*see* *¶ 7:228*).

• [8:129] **Exchanges accompanied by boot:** An exchange that results in the shareholder receiving cash or other property in addition to securities results in taxable income to the extent of the "boot" received. [IRC § 356]

• [8:130] **Exchanges with "bail out" potential:** Where preferred shares are issued in exchange for outstanding common shares, and the exchanging shareholders retain other common shares, there is a potential for "bailing out" corporate earnings, and therefore the preferred shares may be treated as "Section 306 stock" (*see* *¶ 7:296*).

c. [8:131] **Forms of recapitalization:** The following are the most commonly encountered forms of recapitalization, and the particular considerations applicable to them:

(1) [8:132] **Exchanges of "new" preferred for "old" common:** Pursuant to a plan or agreement with its shareholders, a corporation may issue preferred stock, having designated rights and preferences, in exchange for some of its outstanding common stock.

(a) [8:133] **Purpose:** The purpose usually is to facilitate *transfer of control* (and risk) from one group of shareholders to another; e.g., as where older shareholders wish to retire from active management in favor of other, younger shareholders. The older shareholders end up with preferred shares, giving them greater security as to income, priority on liquidation, etc. The younger shareholders end up with control of the corporation, and greater growth opportunity (and risks).

(b) [8:134] **Example:** Parent, the principal shareholder of XYZ Corp., wants to encourage Child to participate in ownership. Yet Parent wants to retain control of the corporation and have an adequate income during Parent's lifetime. Parent also wants to fix the value of Parent's shares ("freeze" the value for estate tax purposes), so future growth will inure to Child.

Parent can amend the articles to authorize a new class of voting preferred shares (with the desired dividend and liquidation preferences), and a class of nonvoting common. Parent would then exchange Parent's existing common shares for the new preferred and the nonvoting common (allocating to the preferred substantially the full value of Parent's investment). Parent would then make a gift of the nonvoting common shares to Child. (There is no gift tax to pay because the nonvoting common has little present value.)

If properly implemented as a tax-free recapitalization, Parent will have frozen the value of Parent's investment, and all future growth will go to Child (through the common shares). At the same time, Parent will have retained control (through the voting preferred). Later, Parent can transfer voting control to Child by inter vivos or testamentary gifts of the preferred.

1) [8:134.1] ***CAUTION:*** The transferred interest still may be subject to a higher gift tax valuation; *see* *¶ 2:240.1*.

(c) [8:135] **Amendment of articles:** Unless the articles already authorize a class of preferred shares having the rights and preferences agreed upon, it will be necessary to amend the articles (requiring shareholder approval) to create such a class.

(d) [8:136] **Tax considerations:** As long as the transferors exchange all of their common stock for preferred, the recapitalization will generally be tax-free under IRC § 354(a) (*¶ 8:125*).

1) [8:137] **Caution—transfer of less than all stock:** If the transferors *retain* any common stock, there is a risk the preferred may be treated as "Section 306 stock." (In determining whether the transferors still own any common shares, the IRC § 318 attribution rules fully apply; *see* *¶ 7:232*.) [IRC § 306(c)(1)(B); Rev.Rul. 59-84, 1959-1 CB 71; *see* *¶ 7:296 ff.*]

2) [8:137.1] **Caution—"nonqualified preferred stock" taxable:** Unless issued in connection with the recapitalization of a "family-owned corporation" (¶ 8:137.2), "nonqualified preferred stock" (i.e., preferred stock having debt-like attributes, *¶ 3:340.1 ff.*) received in exchange for the common stock is treated as taxable "boot." [IRC §§ 354(a)(2)(C)(i), 356(e)]

a) [8:137.2] **Exception for "family-owned corporation":** The rule that treats "nonqualified preferred stock" as boot does *not* apply in a recapitalization of a "family-owned corporation"—i.e., a corporation wherein at least 50% of the voting stock and 50% of all other classes of stock are owned by members of the same family for a period beginning five years before and ending three years after the recapitalization. (Family members include uncles, nieces, cousins, etc.) [IRC §§ 354(a)(2)(C)(ii), 447(d)(2)(C)(i) & (e)]

(2) [8:138] **Exchanges of "new" preferred for "old" preferred:** Another type of recapitalization is for the corporation to issue "new" preferred stock, having designated rights and preferences, in exchange for an existing class of preferred stock having different rights and preferences. [See Corps.C. § 903(a)(2), (5), (6), (7)]

(a) [8:139] **Purpose:** This kind of recapitalization is often encountered with corporations having financial problems. It provides changes in the dividend rates or other priorities, or even the elimination of cumulative dividend arrearages, in order to obtain additional capital from other investors or lenders.

(b) [8:140] **Amendment of articles:** An amendment of the articles will ordinarily be required to create and authorize the "new" preferred (requiring shareholder approval by voting shares and by the "old" preferred shares, voting or not; Corps.C. § 903(a); ¶ *8:54*).

(c) [8:141] **Tax considerations:** In addition to the general reorganization rules (IRC §§ 368(a) and 354), the Code specifically provides that an exchange of preferred-for-preferred in the same corporation is tax-free: "No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation." [IRC § 1036(a)]

1) [8:141.1] **"Nonqualified preferred" taxable:** "Nonqualified preferred stock" issued in exchange for "old" preferred will be taxed as "boot" (unless issued by a "family-owned corporation" or in return for "old" preferred that is also "nonqualified"). [IRC §§ 354(a)(2)(C)(i), 356(e); *see* ¶ *8:137.1 ff.*]

2) [8:142] **Compare—effect of dividend:** However, issuance of "new" preferred may be treated as a taxable *stock dividend* if it results in *disparate treatment* among security holders of the same class (*see* ¶ *7:289*).

For example, "new" preferred shares are exchanged only with certain holders of the "old" preferred, and its fair market value (or liquidation preference) exceeds the original issue price (or liquidation preference) of the surrendered stock. This would result in a disproportionate increase in such holders' ownership interest in the corporation's assets and earnings. [Treas.Reg. § 1.305-7(c)]

(3) [8:143] **Exchanges of "new" common for "old" preferred:** This form of recapitalization is encountered whenever the outstanding preferred shares have *conversion rights*, making them convertible into common. Upon exercise of such rights, the "old" preferred is exchanged for "new" common.

Amendment of the articles is required only if there is not enough common stock remaining unissued under the corporation's original authorized capital (¶ *8:288*).

Again, such exchange of "stock for stock in the same corporation" is normally tax-free. Gain or loss is deferred until the shares are ultimately sold. [IRC § 354(a), ¶ 8:136; Treas.Reg. § 1.368-2(e); and Rev.Rul. 77-238, 1977-2 CB 115]

(4) [8:144] **Exchanges of "new" common for "old" common:** As with exchanging "new" preferred for "old" common, this form of recapitalization can be used to transfer or alter control of the corporation. For example, issuing nonvoting common stock in exchange for outstanding voting shares (or vice versa).

Unless the "new" common shares had been previously authorized (which is rarely the case), amendment of the articles will be required (¶ *8:28*).

Again, such an exchange is generally tax-free. [IRC §§ 1036, 368, 354]

(5) [8:145] **Exchanges of "new" stock for "old" debt:** Not infrequently, a corporation may enter into an agreement with its creditors to issue shares of stock (either common or preferred) in exchange for outstanding debt securities (bonds, debentures, notes, etc.). The usual purpose is to "clean up" or strengthen the corporation's balance sheet, and thus perhaps to encourage others to invest in or make loans to the corporation.

Amendment of the articles is usually required only where, to effect the exchange, it needs more shares than it has remaining unissued from its original authorized capital (¶ *8:28*).

(a) [8:145.1] ***Caution—possibility of income to corporation:*** To the extent the *fair market value* of the stock is *less* than the amount of the debt, the corporation must recognize the difference as *income* from discharge of indebtedness. [IRC § 108(e)(8)]

(6) [8:146] **Exchanges of "new" debt securities for "old" debt:** These are basically *refinancing* transactions. For example, the holders of existing bonds or debentures may be offered "new" debt having extended maturity, but with higher interest rates, better lien protection, etc.

(a) [8:147] **Tax considerations:** The exchange is tax-free as long as the *principal* amount of the debt is unchanged. [IRC § 354(a)]

[8:148] In contrast, where a *greater* amount is due under the "new" debt securities than under the securities surrendered, the fair market value of the excess is treated as "boot" to the security holder. [IRC §§ 354(a)(2), 356(d)(2)(B)]

[8:149] Compare: If a *lesser* amount is due under the "new" securities, the difference may be taxable income to the *corporation* (as forgiveness-of-debt income). [IRC §§ 108(e), 61(a)(12)]

(7) [8:150] **Compare—exchanges of "new" debt for "old" stock:** The issuance of debt securities (bonds, debentures, notes) solely in exchange for outstanding stock is *not* a tax-free recapitalization. Rather, it is taxed as a *redemption* of the surrendered stock (*see ¶ 7:228, 7:231.3, 8:128*). [Treas.Reg. § 1.354-1(d)]

[8:151] If the "old" stock was exchanged for a *combination* of debt securities and *some* "new" stock, the transaction would be treated as a tax-free exchange of stock (IRC § 356), with the value of the debt securities taxed as "boot." [IRC §§ 354(a)(2), 356(d)]

(8) [8:152] **Plan essential:** To qualify for tax-free treatment, a recapitalization must be pursuant to a formally-adopted plan (i.e., directors' resolutions, shareholders' approval, etc.). The plan must contain a detailed description of the exchange and a statement of its business purpose. [Treas.Reg. §§ 1.368-2(g), 1.368-3(a)]

[8:152.1 - 8:152.5] ***Reserved.***

d. [8:152.6] **Securities law requirements:** An exchange of securities for other securities is considered a "sale" under both federal and California law. [See SA § 2(a)(3); Corps.C. § 25017(a)]

A change in the rights under or restrictions on outstanding securities is also considered a "sale" under California law (Corps.C. § 25017(a)), but not under federal law. Therefore, *federal* securities law issues arise only in recapitalizations involving *exchanges* (unless the corporation is a 1934 Act reporting company, in which event the federal *proxy* rules (SEA § 14) may apply to recapitalizations requiring *shareholder approval*).

(1) [8:153] **Federal and state exemptions for exchange with existing security holders:** An exchange of securities with a corporation's existing security holders exclusively is *exempt* from the 1933 Act registration requirements and the California qualification requirements so long as no commission or other remuneration is paid for soliciting the exchange. [SA § 3(a)(9); Corps.C. § 25102.1(c)]

(a) [8:153.1] **Comment:** Corps.C. § 25102.1(c) exempts an offer or sale that is exempt under SA "Section 18(b)(4)(C)," which formerly referred to exemptions under SA § 3(a). Section 18(b)(4)(C) has been redesignated § 18(b)(4)(E) by several amendments to the Securities Act. [See Jumpstart Our Business Startups Act (JOBS Act), Pub.L. 112-106 (126 Stats. 306), § 305(a); Fixing America's Surface Transportation Act (FAST Act), Pub.L. 114-94 (129 Stats. 1312), § 76001(b)]

Section 18(b)(4)(C) now refers to SA § 4(a)(6), the crowdfunding exemption (*¶ 5:106 ff.*). Accordingly, Corps.C. § 25102.1(c) no longer refers to an exemption for the exchange of securities with a corporation's existing security holders but, rather, to the offer and sale of securities in exempt crowdfunding issuances. This leaves in doubt the status of the § 25102.1(c) exemption for an exchange of securities with the corporation's existing security holders. The outdated reference should be corrected by the Legislature, or by the Commissioner pursuant to the Corps.C. § 25105 rulemaking authority.

[8:153.2 - 8:153.4] ***Reserved.***

(2) [8:153.5] **Other *state law exemptions:*** Even where the exchange does *not* fall within the above exemption (i.e., the exchange is not limited to existing security holders or involves payment of a commission; ¶ 8:153 ff.), it may fall within other exemptions from the California qualification requirements. The major ones are described below (¶ 8:153.6 ff.).

(a) [8:153.6] **Securities of "listed" corporations:** State law conforms to the 1933 Act preemption provisions (*see ¶ 5:18.6*) by expressly exempting from all qualification requirements, *and from notice and fee filing requirements*,

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

securities listed (or authorized for listing) on the New York Stock Exchange, NYSE American (successor to the American Stock Exchange), Nasdaq Global Market or Nasdaq Global Select Market, as well as securities (including debt instruments) equal or senior to these securities. [Corps.C. § 25100.1(a); see SA § 18(a), (b)(1)]

1) [8:153.7] **Proxy rules applicable:** One of the prerequisites for listing on the New York Stock Exchange, NYSE American and Nasdaq is that the corporation must be a 1934 Act reporting company. Consequently, a corporation that qualifies for the "listed corporation" exemption is ipso facto subject to the SEA § 14 proxy requirements for any *shareholder approval* sought in connection with the recapitalization.

(b) [8:153.8] **SEC Rule 506 and "qualified purchasers":** Conforming again to the 1933 Act preemption provisions (*see ¶ 5:18.6*), California exempts from the qualification requirements (except for a "notice" filing and accompanying fees, ¶ 5:185.1) any offer or sale of securities (i) to "qualified purchasers," as defined by SEC rules (at present, the only such SEC rule is Rule 256, which applies to Reg. A, Tier 2 offerings; *see ¶ 5:190.6*), or (ii) in reliance on SEC Rule 506 (¶ 5:171 ff.) or such other SEC rules or regulations as may be issued in the future under SA § 4(a)(2). [Corps.C. § 25102.1(a); see SA § 18(a), (b)(3) & (4)(F)]

[8:154 - 8:155] ***Reserved.***

(c) [8:156] **Exemptions pertaining to recapitalizations:** An exchange of securities for other securities may be exempt from qualification under the recapitalization exemptions set forth in Corps.C. § 25103, discussed earlier in connection with "Amendment of Articles" (*see ¶ 8:90 ff.*).

In addition, the Financial Protection and Innovation Commissioner (formerly the Business Oversight Commissioner) has, by rule, specifically exempted exchanges of securities by the corporation where:

• The exchange is *exclusively with existing security holders* (or changes in the rights or restrictions of their securities); and

• An original issuance of such securities would have been exempt under Corps.C. § 25102 (including the Corps.C. § 25102(f) "limited offering" exemption and the Corps.C. § 25102(n) "qualified purchaser" exemption). [Commr. Rule 260.103(a)(1)]

1) [8:156.1] **Notice requirement:** Although exempt under such Rule, the corporation is required to file *notice* of any such exchange with the Financial Protection and Innovation Commissioner if the exemption so requires. [Commr. Rule 260.103(b); *see ¶ 5:294 ff., 5:304.24 ff.*]

(3) [8:157] **Qualification procedure:** Where no exemption applies, a recapitalization—i.e., an exchange of securities by a corporation with its existing security holders or any material change in the rights under or restrictions on their securities must be qualified by permit (and if no federal exemption applies, must be registered with the SEC). [Corps.C. §§ 25120(a)(1), (2), 25121]

FORM: The Commissioner's form, Application for Qualification of the Offer and Sale of Securities Under the Corporate Securities Law of 1968, and Instructions for Application for Qualification of Recapitalizations and Reorganizations (Section 260.121), are available online at the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

(a) [8:158] **Commissioner's standards:** A permit may be conditioned on the corporation's obtaining an affirmative vote of a specified percentage of the outstanding stock (excluding shares held by persons having a conflict of interest in connection with the adoption of the reorganization plan). [Commr. Rule 260.140.61]

(b) [8:159] **Hearings:** The corporation may request a hearing on the application for permit to issue securities in any recapitalization or reorganization. Also, under "unusual circumstances," the Financial Protection and Innovation Commissioner may initiate and order such a hearing. [Commr. Rule 260.140.62]

(c) [8:160] **Soliciting shareholder approval:** Shareholder proxies or consents to a recapitalization (or other reorganization) may not be solicited until *after* a permit has been issued.

Moreover, any materials distributed to the shareholders designed to elicit their approval must be cleared in advance with the Financial Protection and Innovation Commissioner. (Preliminary copies must be attached as an exhibit to the application for permit.) [Commr. Rule 260.140.60]

3. [8:161] **Mergers:** A merger is a reorganization in which one corporation is absorbed into another. By plan or agreement, shares of stock in the absorbed or "disappearing" corporation are converted into the right to receive shares of stock or other securities (or cash) of the "survivor" corporation. Provided statutory requirements are met, the assets and liabilities of the disappearing corporation are transferred by operation of law to the survivor. [See Corps.C. §§ 1100-1113; see also Corps.C. §§ 3200-3203 (SPCs); and *North Valley Mall, LLC v. Longs Drug Stores Calif., LLC* (2018) 27 CA5th 598, 602, 238 CR3d 368, 371]

[8:162] **Compare—consolidations:** A consolidation is also a combination of two or more existing corporations, but instead of absorbing one into the other (as in a merger), the two are "consolidated" by merging into a *third* corporation (the "survivor"). The procedures for mergers and consolidations are identical, and there is no distinction drawn under the Corporations Code. [See *Ortiz v. South Bend Lathe* (1975) 46 CA3d 842, 848, 120 CR 556, 559 (disapproved on other grounds by *Ray v. Alad Corp.* (1977) 19 C3d 22, 34, 136 CR 574, 582)]

a. [8:163] **Types of mergers:** A merger transaction may take various forms, of which the following are most common:

(1) [8:164] **Straight merger:** One or more corporations are merged into a surviving corporation, with the shareholders (and other security holders) of all the constituent corporations becoming shareholders (and/or security holders) of the survivor (except to the extent any of them are "cashed out" in the merger).

(2) [8:165] **Triangular merger:** One corporation (parent) acquires another (target) by merging it into a third corporation, which is a wholly-owned subsidiary of the parent. The shareholders of the acquired corporation, however, receive stock or securities of the *parent* corporation (rather than of the subsidiary-"survivor").

The result is to keep the acquired corporation's assets and liabilities in a separate entity (the wholly-owned subsidiary), rather than the parent absorbing them directly as in a straight merger. But the acquisition is still "paid for" by issuance of the parent's securities.

(3) [8:166] **Reverse triangular mergers:** Where it is important to preserve the target corporation's separate legal identity (e.g., because it holds a valuable nontransferable license or permit), a triangular merger can be effected in which the target, and not the subsidiary, "survives." [See *North Valley Mall, LLC v. Longs Drug Stores Calif., LLC* (2018) 27 CA5th 598, 602-604, 238 CR3d 368, 371-373—"Reverse triangular mergers are a well-recognized method of reorganization that preserves the corporate entity of the target corporation" (internal quotes omitted)]

This is how it works: The acquiring corporation ("parent") forms a wholly-owned subsidiary that is merged into the corporation to be acquired (the "target" corporation), with the "target" as the surviving corporation and a wholly-owned subsidiary of the parent. The "target" corporation's shareholders receive shares of the parent (or other consideration, including cash) for their shares. The "parent" has control of the "target" and the "target's" former shareholders have become shareholders in the "parent" corporation (if they were not cashed out). The legal identity of both the "parent" and the "target" have been preserved intact. [See *North Valley Mall, LLC v. Longs Drug Stores Calif., LLC*, supra, 27 CA5th at 600, 602-603, 238 CR3d at 369, 371 & fn. 1]

(4) [8:167] **Short-form mergers:** Mergers between parent and subsidiary corporations, where the parent owns at least 90% of each class of the subsidiary's stock. Because the parent already has almost complete ownership of the subsidiary, this type of merger is treated differently than other mergers and is *not* subject to the "reorganization" rules of the Corporations Code (*see* ¶ 8:196 ff.).

b. Procedure to effect merger

(1) [8:168] **Plan or agreement of merger:** The first step in a merger is for the constituent corporations to enter into an agreement or plan of merger. [Corps.C. § 1101]

(a) [8:169] **Parties:** The parties to the agreement are the respective ("constituent") corporations. If either is a subsidiary of a third corporation, that parent corporation may also be a party to the merger agreement. [Corps.C. § 1101]

(b) [8:170] **Contents:** The merger agreement must state the following:

- The name and place of incorporation of each constituent corporation to the merger, and which is to be the surviving corporation;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The terms and conditions of the merger, including the manner or ratio by which shares in the disappearing corporation will be converted into shares or other securities of the surviving corporation, and any cash, property or other rights which the existing shareholders are to receive;

• Any other details, including how fractional share interests will be "cashed out" or otherwise treated consistent with Corps.C. § 407 (¶ 8:170.7);

• If the shares are to be cancelled *without* any consideration; and

• Any amendment to the survivor's articles of incorporation to be effected by the merger. [Corps.C. § 1101]

FORM: Agreement of Merger, *see Form 8:E.*

1) [8:170.1] **Terms may be dependent on facts ascertainable outside agreement:** The terms of a merger agreement may be made dependent upon facts ascertainable *outside* of the agreement itself … provided the agreement *clearly* and *expressly* sets forth the *manner* in which such facts operate upon the terms in question. [Corps.C. § 109.5(a); see also Corps.C. § 2502.06(a) (SPCs); *and ¶ 4:60.1*]

Thus, specified terms of a merger agreement may be dependent upon such ascertainable extraneous facts as the price of the constituent corporations' shares.

2) [8:170.2] **Terms may be dependent on extrinsic agreement:** In addition, merger agreement terms may be made dependent upon facts ascertainable outside the merger agreement through reference to an extrinsic *agreement* or document. [Corps.C. § 109.5(a), (b); see also Corps.C. § 2502.06(a), (b) (SPCs)]

Example: By using this procedure, the constituent corporations may form executive committees to work out arrangements for executive compensation and other matters and not include their agreements in the merger instrument.

a) [8:170.3] **Shareholder approval of amendments to extrinsic agreements:** Shareholder approval may be required for any amendment or revision of such an extrinsic agreement if a constituent corporation is a *party* to the agreement. [Corps.C. § 109.5(c); see also Corps.C. § 2502.06(c) (SPCs)]

(Compare: The statute does not require shareholder approval where the corporation is *not a party* to the agreement or to documents referenced in the merger agreement.)

1/ [8:170.4] **Change in shareholder rights, liabilities:** The affected shareholders must approve an amendment to such an extrinsic agreement if it would result in a *material change* in (1) the rights, preferences, privileges or restrictions of any share class or series; or (2) certain enumerated rights or liabilities of any share class or series (*see ¶ 4:60.3 ff.* for list). [Corps.C. § 109.5(c)(1)-(3); see also Corps.C. § 2502.06(c)(1)-(3) (SPCs)]

2/ [8:170.5] **Change in principal terms of merger agreement:** Moreover, if any amendment or revision of the extrinsic agreement would result in a change in any of the *principal* terms of the merger agreement, it must be approved by the shareholders of the constituent corporations, just as if the "principal terms" of the merger agreement itself were being amended (*see ¶ 8:184*). [Corps.C. § 109.5(c)(4); see also Corps.C. § 2502.06(c)(4) (SPCs)]

b) [8:170.6] **Copies must be maintained:** The constituent corporations must maintain copies of such extrinsic agreements (and all amendments thereto) at their principal offices. If the shareholders of any constituent corporation request the agreements in writing, they must be provided with copies free of charge. [Corps.C. § 109.5(b); see also Corps.C. § 2502.06(b) (SPCs)]

3) [8:170.7] **Agreement must provide fair treatment for fractional share interests:** The merger agreement must provide for cash payments in lieu of fractional shares or for any other treatment of fractional share interests consistent with Corps.C. § 407. [Corps.C. § 1101(e)]

4) [8:170.8] **Equal treatment for all shares of same class:** Each share of the same class (or series) must be treated equally regarding any distribution of cash, property, rights or securities in the merger … unless *all* shareholders of the class (or series) agree otherwise. [Corps.C. § 1101, last para.]

a) [8:170.9] **Exception—shares held by constituent corporation:** However, shares of one constituent corporation held by another constituent corporation to the merger (or by its parent or a wholly-owned subsidiary of either) may

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

be treated differently from other shares—i.e., cancelled rather than cashed out, exchanged for other shares, etc. [Corps.C. § 1101, last para.]

➪ [8:170.10] ***PRACTICE POINTER:*** Be sure the surviving corporation has enough *authorized but unissued* shares to effect the merger. If not, the articles will have to be amended (*see ¶ 4:28 ff., 8:28 ff.*).

(c) [8:171] **Execution:** Each corporation must sign the merger agreement by its chairperson of the board, president or a vice president, *and* its secretary or an assistant secretary. [Corps.C. § 1102]

(2) [8:172] **Board approvals:** The boards of each corporation (and of any *controlling parent corporation* whose equity securities are being issued in the merger) must adopt and approve the merger agreement and authorize or ratify its execution by corporate officers. [Corps.C. § 1101, first para.]

(a) [8:172.1] **Caution:** The board has a clear responsibility to inform itself of the merger terms before adopting and approving the merger. This includes reviewing the merger agreement and related documents. Directors should *not* rely solely on representations of management. [See *Smith v. Van Gorkom* (Del. 1985) 488 A2d 858, 874 (overruled on other grounds by *Gantler v. Stephens* (Del. 2009) 965 A2d 695, 713, fn. 54), *discussed at ¶ 6:247.2*]

Also, the board and officers may have a duty to disclose the merger even before agreement has been reached on its principle terms (*see ¶ 6:370.1 ff.*).

(b) [8:172.1a] **Approval of parent's share issuance:** If shares of a controlling parent corporation are to be issued in the merger, the parent's board must also approve the share issuance and state in the approving resolution the *fair value* to the corporation in monetary terms of the consideration to be received for its shares. [Corps.C. § 409(e)]

(c) [8:172.2] **Agreement may be made binding and exclusive:** Where the proposed merger is with an *unaffiliated* party (i.e., *not* proposed by the corporation's controlling persons or management), the agreement may be made binding and govern the parties' conduct pending submission for shareholder approval (e.g., it may require the directors to use their "best efforts" or "commercially reasonable efforts" to obtain such approval). Moreover, the respective boards may make the merger agreement *exclusive*—i.e., it may forbid negotiating or accepting competing offers prior to any shareholder vote. [See *Monty v. Leis* (2011) 193 CA4th 1367, 1374, 123 CR3d 641, 646-647; *Jewel Companies, Inc. v. Pay Less Drug Stores Northwest, Inc.* (9th Cir. 1984) 741 F2d 1555, 1564 (applying Calif. law)]

1) [8:172.3] **Board duties re competing offers (publicly-held companies):** It is now generally accepted, based upon Delaware law, that the board of a publicly-held company may not, consistent with its fiduciary duties, agree to defensive measures that would prevent the corporation from accepting a superior offer received after the merger agreement is entered into and before the shareholder vote. Such defensive measures include irrevocable voting agreements from director and director-affiliated shareholders, a "force-the-vote" provision (requiring the board to submit the merger agreement to the shareholders for their approval even in the face of a superior offer), a provision barring the board from withdrawing its favorable recommendation of approval, and the absence of a "fiduciary out" (*see ¶ 8:172.4*). "To the extent that a [merger] contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable." [See *Omnicare, Inc. v. NCS Healthcare, Inc.* (Del. 2003) 818 A2d 914, 936-939, quoting *Paramount Communications Inc. v. QVC Network Inc.* (Del. 1994) 637 A2d 34, 51]

a) [8:172.3a] **Comment:** Although the court in *Monty*, supra (*¶ 8:172.2*), held that the board did not have a duty to include a fiduciary out, the transaction in question *did not require shareholder approval*. And while the Ninth Circuit in *Jewel Companies*, supra (*¶ 8:172.2*), concluded that the board could enter into an "exclusive" merger agreement, it acknowledged that the board could *not*, consistent with its fiduciary obligations, *withhold informing the shareholders of a potentially more attractive competing offer*. [See *Monty v. Leis* (2011) 193 CA4th 1367, 1370-1371, 123 CR3d 641, 644; *Jewel Companies, Inc. v. Pay Less Drug Stores Northwest, Inc.* (9th Cir. 1984) 741 F2d 1555, 1564]

➪ [8:172.4] ***PRACTICE POINTER:*** "Fiduciary outs" (contractual provisions allowing the board to terminate a merger agreement in order to accept a superior proposal received after the merger agreement is entered into and before the shareholder vote) are now common in merger agreements with public company targets. They are typically paired with a provision requiring the target company to pay a termination fee to the "jilted suitor" if the target's board terminates the merger agreement to accept a superior proposal. Such "fiduciary outs" implement "the board's

continuing responsibility to effectively exercise its fiduciary duties at all times after the merger agreement is executed …" [*Omnicare, Inc. v. NCS Healthcare, Inc.* (Del. 2003) 818 A2d 914, 930]

(d) [8:172.5] **Mergers proposed by insiders:** If the merger is proposed by an *insider*—i.e., an "interested party"—special requirements are imposed to assure that the shareholders will be treated fairly in the non-arm's-length transaction.

1) [8:172.6] **Who is an "interested party":** The special requirements apply to merger proposals made to a corporation by anyone who:

• Directly or indirectly *controls* the corporation;

• Is directly or indirectly controlled by any of the corporation's officers or directors; or

• Is an entity in which any of the corporation's directors or "executive officers" (i.e., president, vice-president, or other persons serving similar policymaking functions) holds a *material financial interest*. [Corps.C. § 1203(a)]

a) [8:172.7] **Exception—corporations with fewer than 100 shareholders:** The special requirements set forth in § 1203(a) do not apply where the merger proposal is made to a corporation with *fewer than 100* shareholders of record. [Corps.C. § 1203(a), last para.]

b) [8:172.8] **Exception—mergers qualified by permit:** Nor do the special requirements of § 1203(a) apply to "a transaction" (presumably, the issuance of securities) that is qualified by permit under Corps.C. § 25113 or § 25121. [Corps.C. § 1203(a), last para.]

1/ [8:172.8a] **Comment:** Section 1203 applies to reorganizations and tender offers involving securities or only cash.

A question arises if the issuance of securities is exempt from qualification, as where, for example, the transaction or the securities offered to the "target" shareholders in a proposed merger are "preempted" (e.g., listed or authorized for listing on an approved exchange; *see ¶ 5:18.6*). Presumably, if the purpose of the qualification exemption is to provide the protections of a Commissioner review, the transaction would still be subject to Corps.C. § 1203(a) and its requirement of a "fairness opinion" (¶ 8:172.9). (Even if exempt by reason of the limited shareholder exemption (¶ 8:172.7) or the qualification exemption (¶ 8:172.8), a tender offer or reorganization covered by Corps.C. § 1203 is still subject to the requirements of Corps.C. § 1203(b) re competing offers (¶ 8:172.12 ff.).)

On the other hand, if the proposed "preempted" issuance does not qualify for the qualification exception to the § 1203(a) requirements, a question of federal preemption might arise, given the broad language of SA § 18 exempting from state regulation securities transactions involving preempted securities transactions.

2) [8:172.9] **Independent fairness opinion:** The interested party must provide the shareholders with an independent written opinion as to the fairness of the consideration they will receive in the transaction. [Corps.C. § 1203(a)]

a) [8:172.10] **Opining person's qualifications:** The opinion must be provided by someone who:

• Engages for compensation in "the business of advising others as to the value of properties, businesses, or securities" (e.g., an investment banker, California probate referee, etc.); and

• Is *unaffiliated* with the offeror (however, a person who previously rendered services to the offeror or a related entity, or who is simultaneously providing advice or assistance regarding the proposed transaction on a contingent fee basis, is not necessarily disqualified). [Corps.C. § 1203(a), penultimate para.]

b) [8:172.11] **Delivery of opinion:** The fairness opinion must be delivered to the shareholders with the notice of the meeting at which the merger is to be approved. Where written shareholder consents are solicited, the opinion must accompany the solicitation.

If shareholder approval is not required to consummate the transaction (*see ¶ 8:178 ff.*), the opinion must be delivered to the board of directors before it authorizes completion of the transaction. [Corps.C. § 1203(a)(1)]

3) [8:172.12] **Competing offers:** The board of directors must notify the shareholders of any later competing offer requiring shareholder acceptance or approval made at least 10 days before the interested party proposal is to be approved, whether a tender offer, a merger offer, a stock-for-stock exchange (*¶ 8:235 ff.*), a sale-of-assets

reorganization (¶ *8:259 ff.*) or a straight sale-of-assets (¶ *8:581 ff.*). The directors must also forward to the shareholders any written materials provided by the later offeror (at such offeror's expense). [Corps.C. § 1203(b)(1)]

a) [8:172.13] **Insider proposal delayed pending shareholder action on competing offer:** Further, the directors must delay completion of the interested party transaction for at least 10 days after notifying the shareholders of the competing offer. The purpose is to give them a reasonable opportunity to withdraw any vote, consent or proxy previously given in connection with the interested party merger proposal. [Corps.C. § 1203(b)(2)]

b) [8:172.14] **Improving insider offer:** Insiders can always *improve* their offers when faced with a competing offer ("up-the-ante"). But, in this event, the other bidders can also amend their offers; and the above-described procedures (¶ 8:172.12) would presumably apply to *each* further offer.

➪ [8:172.15] ***PRACTICE POINTER*:** When submitting an insider proposal to the shareholders for approval, the corporation should disclose that competing offers received 10 days before the proposal is approved will be submitted for shareholder consideration.

(3) [8:173] **Shareholder approvals:** The merger agreement must also be approved by majority vote of *each class of shares of each corporation* whose board approval was required (¶ *8:172*)—whether or not that class otherwise has voting rights (except as noted below, ¶ 8:174 ff.). [Corps.C. § 1201(a)]

(a) [8:173.1] **Before or after board approval:** Such shareholder approval may be given either before or after approval by the respective boards of directors. [Corps.C. § 1201(i)]

(b) [8:174] **Mergers requiring greater-than-majority approval:** There are a number of situations in which more than a mere majority of each class is required:

1) [8:175] **Articles so require:** If the articles of either corporation require approval by more than a majority of the shares of each class (either for reorganizations or for shareholder action generally), such provisions control. [Corps.C. §§ 1201(a), 152]

2) [8:176] **Disappearing close corporation:** If a statutory close corporation is merged into a survivor corporation that is *not* a close corporation, at least *two-thirds* (or greater vote if required by the articles) of each class of the close corporation's shares must approve the merger. (The articles may reduce the two-thirds requirement, but not to less than a majority.) [Corps.C. §§ 1111, 1201(e); see also Corps.C. § 3200 (SPCs)]

3) [8:176.1] **Surviving SPC and disappearing nonSPC:** If an SPC is the survivor in a merger with a corporation that is *not* an SPC, at least *two-thirds* (or greater vote if required by the articles) of each class of the disappearing corporation's shares must approve the merger. [Corps.C. §§ 1112.5, 1201(f)]

Similarly, if an SPC is merged into a nonSPC corporation or an SPC whose articles set forth "materially different purposes," the merger must be approved by affirmative vote of at least *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class regardless of whether the articles entitle that class to vote on the transaction. [Corps.C. § 3201; *see* ¶ *9:313*]

4) [8:176.2] **Merger with benefit corporation:** If a corporation is merged into a benefit corporation, or if the merger would have the effect of terminating the status of a corporation as a benefit corporation, the merger must be approved by at least *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class or series of stock regardless of any limitation stated in the articles or bylaws on the voting rights of any class or series. [Corps.C. §§ 14603(b), 14604(b); see Corps.C. § 14601(d)(1), ¶ *9:537*]

5) [8:176.3] **Merger into nonprofit corporation:** A merger into a nonprofit public benefit corporation, nonprofit mutual benefit corporation or nonprofit religious corporation must be approved by *all* the outstanding shares of all classes of the disappearing corporation regardless of limitations or restrictions on their voting rights. [Corps.C. § 1112; see also Corps.C. § 3202 (SPCs, ¶ *9:314*)]

6) [8:177] **Disparate treatment within class:** Equal treatment among shares of the same class is required unless 100% of the shareholders agree otherwise. Thus, if the merger plan calls for *unequal* distributions of cash, property or other securities among shareholders of the same class, the merger agreement must be approved by *all* shares of that class. [Corps.C. §§ 1101 (last para.), 1113(c), 1101.1]

a) [8:177a] **Caution—potential effect of Financial Protection and Innovation Commissioner approval:** Prior to its amendment in 2015, § 1101.1 provided that "the last two sentences of Section 1101"—which contain the unanimous consent requirement for unequal distributions among shareholders of the same class—did not apply to

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

any transaction approved by the Commissioner of Financial Protection and Innovation following a hearing on the fairness of the merger's terms and conditions. [Former Corps.C. § 1101.1; see Corps.C. § 25142]

However, in the amendment effective January 1, 2016, the reference in § 1101.1 to "the last two sentences of Section 1101" was changed to "Subdivision (b) of Section 1101." Thus, § 1101.1 no longer permits a variation in the equal treatment requirement for a transaction approved in a "fairness" hearing. [Corps.C. § 1101.1]

Elimination of the fairness hearing exception clearly appears inadvertent, as § 1101.1 continues to apply the fairness hearing exception to interspecies mergers (per Corps.C. § 1113(c), ¶ *8:210.15 ff.*). Moreover, the reference to § 1101(b) is nonsensical. And there is nothing in the legislative history of the 2015 amendment to indicate the Legislature intended to make a substantive change to § 1101.1.

7) [8:177b] **"Controlled" merger—disappearing corporation's common shareholders receive other than common shares:** Where one constituent corporation (or its parent) directly or indirectly owns more than 50% of the voting power of another constituent corporation (but less than 90% of each class), the nonredeemable common stock or nonredeemable equity securities of the disappearing corporation may be converted only into nonredeemable common stock of the surviving corporation (or its parent) *unless all the holders of such common stock unanimously consent to receiving other consideration.* [Corps.C. § 1101, last para.]

a) [8:177c] **Caution—potential effect of Financial Protection and Innovation Commissioner approval:** Prior to its amendment in 2015, § 1101.1 provided that "the last two sentences of Section 1101"—which contain the requirement for unanimous consent to receipt of consideration other than nonredeemable common stock—did not apply to any transaction approved by the Commissioner of Financial Protection and Innovation following a hearing on the fairness of the merger's terms and conditions. [Former Corps.C. § 1101.1; see Corps.C. § 25142]

However, in the amendment effective January 1, 2016, the reference in § 1101.1 to "the last two sentences of Section 1101" was changed to "Subdivision (b) of Section 1101." Thus, § 1101.1 no longer permits a variation in the requirement to issue only nonredeemable common shares for a transaction approved in a "fairness" hearing. [Corps.C. § 1101.1]

Elimination of the fairness hearing exception clearly appears inadvertent, as § 1101.1 continues to apply the fairness hearing exception to *interspecies* mergers (per Corps.C. § 1113(c), ¶ *8:210.15 ff.*). Moreover, the reference to Corps.C. § 1101(b) is nonsensical. And there is nothing in the legislative history of the 2015 amendment to indicate the Legislature intended to make a substantive change to § 1101.1.

b) [8:177d] **Controlling entity has burden of proving fairness:** In any action challenging the validity of a "controlled" merger, the controlling entity has the burden of proving the transaction is "just and reasonable" to the controlled entity's shareholders. [Corps.C. § 1312(c); *see* ¶ *8:365 ff.*]

8) [8:177.1] **Shares cancelled without any consideration:** If the merger agreement provides that all outstanding shares are to be cancelled without consideration, its principal terms must be approved by *all outstanding shares*. [Corps.C. § 1202(a)]

9) [8:177.2] **Preferred shares to receive less than required by articles:** The principal terms of a merger agreement providing that a class (or series) of preferred shares will receive less than required by applicable articles provisions must be approved by the same percentage of outstanding shares of the affected class (or series) as would be required to amend the articles provisions accordingly (*see* ¶ *8:38 ff.*). [Corps.C. § 1202(b)]

(c) [8:177.3] **Foreign parent corporation shareholder approval:** Shareholder approval of a merger involving issuance of equity securities by a controlling *foreign* corporate parent (e.g., a triangular merger; ¶ *8:165*) is governed by the law of the state in which the foreign corporation is incorporated, unless it is a pseudo-foreign corporation subject to Corps.C. § 2115 (*see* ¶ *3:5 ff.*). [Corps.C. § 1202(c)]

(d) [8:178] **Exceptions—mergers NOT requiring shareholder approval:** There are also a few situations in which majority shareholder approval is not required:

1) [8:179] **Preferred shares unaffected by merger:** Approval is not required by the holders of preferred shares of the survivor corporation (or parent in a triangular merger) if they otherwise have no voting rights and their preferences, privileges and restrictions are unchanged by the merger. [Corps.C. § 1201(a)]

2) [8:180] **Certain "short-form" mergers:** Shareholder approval is not ordinarily required for mergers between parent and subsidiary corporations (one at least 90% owned by the other). In most cases, a "short-form" merger can

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

be effected solely by the board(s) of directors—solely by a "100%-owning" parent's board and, otherwise, by both the parent's and subsidiary's boards. Exception: In a "downstream" merger, each class of the parent's shareholders must approve the merger's principal terms if they will receive shares with different attributes than those converted. (*See further discussion at ¶ 8:196 ff.*) [Corps.C. § 1110]

3) [8:181] **Mergers resulting in limited dilution of voting power:** Nor is approval required by the holders of voting shares of either corporation if they as a group retain more than 5/6ths (83.3%) of the voting power after the merger; i.e., if they suffer at least one-sixth (16.7%) dilution of their voting power, their approval must be obtained. [Corps.C. § 1201(b)]

a) [8:182] **Measuring dilution:** So long as the increase in outstanding voting shares is *less than 20%*, the "limited dilution test" is met, and shareholder approval is not required.

"Voting power" is determined by assuming that all securities convertible into voting shares have been converted. But mere options or warrants to purchase voting shares are disregarded. [Corps.C. § 1201(b)]

b) [8:183] **Limitations:** The result is different, and approval by shareholders is still required, in the following cases:

1/ [8:183.1] **Articles amendment required:** The merger requires *amendment* of the surviving corporation's *articles*. [Corps.C. § 1201(c)]

2/ [8:183.2] **"Different" shares received:** As a result of the merger, they receive shares in any way *different* from those previously held (shares in a foreign corporation are deemed different). [Corps.C. § 1201(d)]

3/ [8:183.3] **Disappearing close corporation:** Approval will still be required (ordinarily, by two-thirds vote) of shareholders of a close corporation who receive shares of a *non*-close corporation in the reorganization. [Corps.C. §§ 1111, 1201(e); *see ¶ 8:176*]

(4) [8:184] **Amendments to merger agreement:** A merger agreement may be amended by the boards of each corporation any time before the merger becomes effective. Even if the original agreement was already approved by the shareholders, the amendments need not be submitted for shareholder approval unless the "principal terms" of the original agreement are changed. In that event, the amendment is subject to the same shareholder approval requirements as the original merger agreement. [Corps.C. § 1104; *see ¶ 8:173 ff.*]

➪ [8:185] ***PRACTICE POINTER:*** Since obtaining shareholder approval may be burdensome and costly, consider including a provision in the original agreement authorizing the board alone to amend the principal terms within prescribed limits. Then, once the shareholders have approved, subsequent changes will not require further approvals.

(5) [8:186] **Power of boards to abandon merger:** Even though a merger has been approved by the shareholders of both corporations, the board of either corporation has power to abandon the proposed merger *without* further shareholder approval. [Corps.C. § 1105]

(a) [8:187] **Compare—contract liability:** However, such abandonment may expose such corporation to contractual liability either to the other corporation or to third parties (e.g., creditor beneficiaries who have detrimentally relied on the contract). [Corps.C. §§ 1105, 1201(i); see also Corps.C. § 3401(h) (SPCs)]

➪ [8:188] ***PRACTICE POINTER:*** The risk of contract liability to either corporation can be reduced or even eliminated by appropriate language in the merger agreement. For example, targets that are public companies typically insist on a "fiduciary out" provision whereby the board can terminate the agreement after following specified procedures and upon payment of a specified break-up fee if, prior to shareholder approval, the company receives an unsolicited "superior" offer (*see ¶ 8:172.3*).

(6) [8:189] **Merger documents filed with Secretary of State:** After the requisite board and shareholder approvals, the surviving corporation must file with the Secretary of State a copy of the agreement of merger accompanied by an officers' certificate of *each corporation* setting forth:

- The number of outstanding shares of each class entitled to vote;
- That the principal terms of the merger were approved by each such class (specifying each class and the required percentage); or in the case of "short-form" mergers (¶ 8:196 ff.) that the agreement was approved by the board alone; and
- Where equity securities of a parent corporation are issued in the merger, that approval of the parent's shareholders was obtained or that none was required. [Corps.C. § 1103]

(The filing fee for a merger is $100; see Gov.C. § 12186(k).)

[8:189.1] The officers' certificate must be signed and verified by the chairperson of the board, president or any vice president, *and* by the secretary, chief financial officer, treasurer or any assistant secretary or assistant treasurer. [Corps.C. § 173]

• ***FORM:*** Certificate of Approval of Agreement of Merger, *see Form 8:F*.

➪ [8:189.2] ***PRACTICE POINTER:*** The "agreement of merger" is not necessarily the same merger agreement that is executed by the parties and presented to the shareholders. To avoid public disclosure of the full merger agreement, practitioners customarily file a separate agreement of merger containing only the information required by Corps.C. § 1101.

(7) [8:190] **Correcting defects in merger documents:** Mistakes or defects in the merger documents (or in their execution) can be corrected by filing a certificate of correction with the Secretary of State (*see ¶ 8:117.1 ff.*). The certificate must be in the form of an officers' certificate of the *surviving corporation* (*see ¶ 8:82*). [Corps.C. § 109(b)]

(8) [8:190.1] **When merger effective:** The merger is effective upon *filing* of the merger documents by the Secretary of State (*¶ 8:189*) … unless a delayed effective date is set forth in the filing pursuant to Corps.C. § 110(c). [Corps.C. §§ 1108(c), 1113(j)(3); see also Corps.C. § 3203(j)(3) (SPCs)]

c. [8:191] **Effect of merger:** On the effective date (¶ 8:190.1), the disappearing corporation ceases to exist. It is absorbed into the surviving corporation, and all of its business, assets, rights and liabilities pass to the survivor by operation of law. The shareholders of the disappearing corporation are now shareholders in the survivor (except to the extent they were cashed out under the terms of the merger agreement). [Corps.C. § 1107(a); see *Marenco v. DirecTV LLC* (2015) 233 CA4th 1409, 1419, 183 CR3d 587, 595 (citing text)—provision in corporation's agreement with employee requiring arbitration of disputes enforceable by surviving entity in employee's postmerger suit against surviving entity; *Maudlin v. Pacific Decision Sciences Corp.* (2006) 137 CA4th 1001, 1016, 40 CR3d 724, 734-735]

(1) [8:192] **Transfer of assets:** The merger itself is effective to transfer to the survivor all of the rights and properties of the disappearing corporation. No further documentation is required. [Corps.C. § 1107(a)]

(a) [8:192a] **Recording merger certificate to effect realty transfer:** *Record* ownership of the disappearing corporation's real property may be transferred into the name of the surviving corporation by recording a certified copy of the agreement or certificate of merger in the recorder's office of the county in which the property is located. [Corps.C. § 1109]

(b) [8:192.1] **No sales tax:** State sales tax is not applicable to transfers of assets by merger. Thus, where a substantial sales tax is involved, a merger may be preferable over a purchase of assets (*¶ 8:259 ff.*).

(c) [8:192.2] **Local business licenses and permits:** So long as the merger does not involve a "change of ownership" (¶ 8:192.3), the surviving corporation succeeds, without payment of any transfer fee, to all licenses, permits, registrations and other privileges granted by any local agency (i.e., county, city or other political subdivision). Of course, the surviving corporation is subject to the disappearing corporation's duties and obligations thereunder. [Corps.C. § 1107(b), (g)]

1) [8:192.3] **"Change of ownership":** "Change of ownership" is not defined. Instead, Corps.C. § 1107(b) provides *examples of mergers not resulting in a "change of ownership*": mergers between (i) a corporation and its wholly-owned subsidiary, (ii) a corporation and the wholly-owned subsidiary of its wholly-owned subsidiary, and (iii) two wholly-owned subsidiaries of the same corporation. [Corps.C. § 1107(b)]

2) [8:192.4] **"Reevaluation" allowed:** Nothing in Corps.C. § 1107(b) limits or restricts a local agency from "reevaluating" privileges received by the successor corporation if the local agency determines, in its sole discretion, that the reevaluation is necessary for *public health, safety or welfare*. [Corps.C. § 1107(f)]

3) [8:192.5] **Tax reassessments allowed:** Similarly, nothing in Corps.C. § 1107(b) limits or restricts a tax assessor from reassessing real property upon a transfer of title. [Corps.C. § 1107(e); *see ¶ 8:118.20*]

[8:192.6 - 8:192.10] ***Reserved.***

(d) [8:192.11] **Attorney-client privilege:** After a merger, the successor corporation becomes the holder of the attorney-client privilege previously held by the disappearing corporation. Hence, the disappearing corporation's former officers and directors can no longer assert or waive the attorney-client privilege once held by the disappearing corporation. [Ev.C. § 953(d); *Venture Law Group v. Sup.Ct. (Singhania)* (2004) 118 CA4th 96, 103-104, 12 CR3d 656, 661]

➪ [8:192.12] ***PRACTICE POINTER:*** The parties to the merger agreement may expressly exclude from the transferred assets designated attorney-client communications, and thus allow the disappearing corporation's former shareholders or other parties to retain the attorney-client privilege with respect to those communications. [See *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP* (Del.Ch. 2013) 80 A3d 155, 161-162]

(2) [8:193] **Transfer of liabilities:** Creditors are fully protected. The surviving corporation is liable by operation of law for the debts of the disappearing corporation. Liens on property of either corporation continue unimpaired (but liens on the disappearing corporation's property are limited to the property affected thereby immediately prior to the time the merger is effective). [Corps.C. § 1107(c)]

Any pending action or proceeding against the disappearing corporation may be prosecuted to a judgment binding and enforceable against the survivor (whether or not named as party to the action). [Corps.C. § 1107(d)]

(a) [8:193.1] **Franchise tax obligations:** The survivor is "deemed to have assumed" the disappearing corporation's obligation to file franchise tax and information returns and to pay any franchise taxes determined to be due. [Corps.C. § 1107.5(a)]

(b) [8:194] **Punitive damages claims:** If punitive damages could have been recovered against the disappearing corporation, they can be recovered against the survivor corporation (even though the survivor otherwise had no responsibility for the wrongful acts involved). [See *Moe v. Transamerica Title Ins. Co.* (1971) 21 CA3d 289, 304-305, 98 CR 547, 557]

(3) [8:195] **Dissenters' rights:** Shareholders entitled to vote on the merger and who oppose it, have the right to be cashed out for the appraised value of their shares. (*See detailed discussion of dissenters' rights at ¶ 8:292 ff.*).

d. [8:196] **Compare—"short-form" mergers:** Streamlined procedures are available for mergers between parent-subsidiary corporations, where the parent owns at least 90% (hereafter "90%-owned") of each class of the subsidiary's outstanding shares. No formal "merger agreement" is required.

The simplified procedures vary depending upon whether the subsidiary merges into the parent ("upstream" merger) or the parent merges into the subsidiary ("downstream" merger). Such mergers can be effected as follows:

(1) [8:196.1] **"Upstream" mergers (subsidiary into parent):** Neither a formal merger agreement nor shareholder approval is required to merge a "90%-owned" subsidiary into its parent corporation.

(a) [8:197] **Wholly-owned subsidiary:** If the subsidiary is 100% owned by its parent corporation, it can be merged into the parent by:

1) [8:198] *Resolution or merger plan* adopted by the *parent* corporation's board of directors providing for the merger and for the parent's assumption (as the surviving corporation) of the disappearing subsidiary's liabilities. (There is no need for any action by the subsidiary's board.) [Corps.C. § 1110(a)]

2) [8:199] Filing with the Secretary of State a *certificate of ownership* of the subsidiary. This consists of an officers' certificate of the parent corporation (*see ¶ 8:189.1*) identifying the corporations being merged, and setting forth the 100% share ownership by the parent of the subsidiary, and the resolution (or merger plan) adopted by the parent's board. [Corps.C. § 1110(a), (e) & (f)]

[8:200] ***Reserved.***

(b) [8:201] **90%-owned subsidiary:** If the parent owns less than 100% of the subsidiary's shares (but at least 90% of each outstanding class), merger into the parent requires a slightly more elaborate procedure in order to protect the minority shareholders in the subsidiary:

1) [8:202] The resolution or merger plan must be adopted by the boards of *both* corporations. [Corps.C. § 1110(a), (b)]

2) [8:203] The *parent* board's resolution or merger plan must state that it assumes the subsidiary's debts. It must also state what it is paying to the minority shareholders of the subsidiary: i.e., what "securities, cash, property or other rights" are to be issued or paid by the parent corporation for each share of stock in the subsidiary not owned by the parent. [Corps.C. § 1110(a) & (b)]

3) [8:204] Along with approval of the resolution or merger plan, the *subsidiary's* board must also approve the consideration to be received by its minority shareholders. [Corps.C. § 1110(b)]

4) [8:205] A *certificate of ownership* must be filed with the Secretary of State in the same manner as with a 100% subsidiary (*see ¶ 8:199*). [Corps.C. § 1110(a) & (e)]

5) [8:205.1] The parent corporation must also mail written *notice* to each *minority shareholder* of record of the subsidiary at least *20 days* before the effective date of the merger (i.e., before filing with the Secretary of State). Such notice must:

• State when the merger will be effective;

• Be accompanied by copies of the resolution or merger plan adopted by the boards of both the parent and subsidiary (which plan or resolution must include a description of the securities, cash, property or rights to be issued, paid, delivered or granted to the minority shareholders upon surrender of their shares to the parent); and

• Furnish information as to the minority shareholders' rights to demand payment of cash for their shares under the Code provisions applicable to dissenting shareholders (Corps.C. § 1301(a); *see* ¶ *8:292 ff.*). [Corps.C. § 1110(h)]

(2) [8:205.2] **"Downstream" mergers (parent into subsidiary):** Streamlined procedures also apply to mergers of parent corporations into their "90%-owned" subsidiaries. (Here, no distinction is made between wholly-owned (100%) or 90%-owned subsidiaries, except for minority shareholder dissenters' rights; ¶ *8:205.9*.)

(a) [8:205.3] **Procedure:** A "downstream" merger may be effected by:

1) [8:205.4] *Resolution* or *merger plan* adopted by *both* the parent's and subsidiary's boards of directors providing for the pro-rata conversion of the parent's outstanding shares into shares of the surviving subsidiary corporation. And the adopted resolution or merger plan must also include the subsidiary's assumption (as the surviving corporation) of the disappearing parent's liabilities. [Corps.C. § 1110(a) & (c)]

2) [8:205.5] *Approval* of the merger's principal terms *by each class of the parent's shareholders* who will receive shares having *different* attributes from those converted. [Corps.C. §§ 1110(c), 1201(d)]

(The *subsidiary's* minority shareholders do not vote on the downstream merger since the vote's outcome is preordained by the "90%-owning" parent's approval.)

3) [8:205.6] Filing with the Secretary of State a *certificate of ownership*. This consists of an officers' certificate of the parent corporation (*see* ¶ *8:189.1*) identifying the corporations being merged and setting forth the share ownership by the parent of the subsidiary, the resolution (or merger plan) and its approval by the parent's board (and shareholders, if required, ¶ 8:205.5) and the subsidiary's board. [Corps.C. § 1110(a), (e)]

4) [8:205.7] Mailing notice to the subsidiary's minority shareholders, if any (¶ 8:205.9).

[8:205.8] ***Reserved.***

(b) [8:205.9] **Dissenters' rights for subsidiary's minority shareholders:** Where the parent owns less than 100% (but at least 90%) of the subsidiary and merges into it, the subsidiary's minority shareholders have the right to be cashed out for the appraised value of their shares. [Corps.C. § 1300(a); *see* ¶ *8:292 ff.*] To protect this right, the parent corporation must mail written *notice* to each of the subsidiary's *minority shareholders* of record at least *20 days* before the effective date of the merger (i.e., before filing with the Secretary of State). Such notice must:

• State when the merger will be effective;

• Be accompanied by copies of the resolution or merger plan adopted by the boards of both the parent and subsidiary (which resolution or plan must include a description of any modification of the shares held by the subsidiary's minority shareholders that will occur as a result of the merger); and

• Furnish information as to the minority shareholders' rights to demand cash payment for their shares under the Code provisions applicable to dissenting shareholders (Corps.C. § 1301(a), ¶ 8:325.1). [Corps.C. § 1110(h)]

(3) [8:206] **Qualification not required:** Provided *no issuance or exchange of securities* is involved, the qualification requirements of the Corporate Securities Law do not apply to:

• Short-form mergers where the minority is entirely cashed out; or

• The merger of a wholly-owned subsidiary into its parent. [Corps.C. § 25120; *Giannini Controls Corp. v. Sup.Ct. (Schutzbank)* (1966) 240 CA2d 142, 154-155, 49 CR 643, 651-652]

(4) [8:207] **Name changes:** As part of a short-form merger, the surviving corporation may change its name by amending its articles in the resolution or merger plan. [Corps.C. § 1110(d)]

(5) [8:208] **Applicability to foreign corporations:** In addition to California parent-subsidiary mergers, the procedure described above (¶ 8:205.2 ff.) also applies to the following "short-form" mergers: (a) California parent-foreign subsidiary, and (b) foreign parent-California subsidiary. But no merger with or into a foreign corporation may be effected unless the laws of its state of incorporation so permit. [Corps.C. § 1110(a) & (g)]

[8:209] And, a foreign parent corporation may not effect a "short-form" merger of its California subsidiary unless it files the required certificate of ownership (¶ *8:199*) or certificate of merger (¶ *8:189*) as to that subsidiary. [Corps.C. § 1110(g)]

(6) [8:210] **Dissenters' rights:** As noted above (¶ *8:205.1*), minority shareholders in the subsidiary are entitled to special notice of a proposed short-form merger, and of their rights to be "cashed out" for the appraised value of their shares. [Corps.C. § 1110(h); see *Berger v. Pubco Corp.* (Del.Ch. 2008) 2008 WL 2224107, rev'd on other grounds (Del. 2009) 976 A2d 132—corporate parent has fiduciary duty under Delaware law to disclose material financial and other information needed to enable minority shareholders to determine whether to exercise appraisal rights]

Dissenters' rights are discussed in detail at ¶ *8:292 ff.* But it should be noted at this point that minority shareholders in a 90%-owned subsidiary are *not limited* to such dissenters' rights. Rather, they may seek *injunctive relief* to restrain or rescind the short-form merger, if unfairness can be shown. (But by seeking equitable relief, they waive their statutory right to be "cashed out.") [Corps.C. § 1312; *see* ¶ *8:366*]

e. [8:210.1] **Compare—mergers with noncorporate entities ("interspecies" mergers):** California corporations can merge with California limited liability companies, limited partnerships, general partnerships, business trusts, real estate investment trusts and/or unincorporated associations (other than nonprofit associations). Either the corporation or the other entity may be the survivor. [Corps.C. §§ 174.5, 1113(a); see also Corps.C. § 3203(a) (SPCs, ¶ *9:312*)]

California corporations can also merge with *foreign* noncorporate entities. *See* ¶ *8:210.26 ff.* [Corps.C. § 1113; see also Corps.C. § 3203 (SPCs)]

➪ [8:210.1a] ***Caveat—tax-free treatment available only in triangular merger*:** A merger between a corporation and a noncorporate entity does *not* qualify as a tax-free "A reorganization" (IRC § 368(a)(1)(A); ¶ *8:211 ff.*) … *except* in the limited circumstance where a corporation merges into a noncorporate entity that is *wholly-owned by another corporation* and the disappearing corporation's shareholders receive stock of the *other corporation* (or its *parent*). [Treas.Reg. § 1.368-2(b)(1)(i), (iii), exs. 2, 4 & 11; *see* ¶ *8:165, 8:219.1*]

In all other mergers involving noncorporate entities (including a *reverse* triangular merger, ¶ *8:166*), securities of the survivor (or its parent) received in exchange for securities of the disappearing entity will be treated as a taxable "sale or exchange" requiring the recognition of any realized gain (or loss). Tax-free treatment will result only if the transaction can be structured to comply with some other applicable Code provision (e.g., IRC § 351, ¶ *2:159 ff.*). [See Treas.Reg. § 1.368-2(b)(1)(iii), exs. 6 & 7]

(1) [8:210.2] **Compliance with laws governing noncorporate entities required:** The discussion below (¶ 8:210.3 ff.) focuses on the relevant law applicable to *corporations*. Noncorporate entities desiring to merge must comply with *their respective governing laws*.

• *Cross-refer:* For a more detailed discussion of mergers involving noncorporate entities, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG).

(a) Entity approval requirements

1) [8:210.3] **General partnerships:** The merger agreement must be approved by the number or percentage of partners specified for merger in the partnership agreement. If the partnership agreement does not specify the required partner approval, the merger must be approved by the number or percentage of partners specified by the partnership agreement to approve an *amendment* to the partnership agreement (unless the merger effects a change for which the partnership

agreement requires a greater number or percentage than that required to amend the agreement, in which event the merger must be approved by that greater number or percentage). If the partnership agreement contains *no* provision specifying the vote required to amend the partnership agreement, the merger must be approved by *all* partners. [Corps.C. § 16911(a)]

2) [8:210.4] **Limited partnerships:** The merger agreement must be approved by *all* general partners; and the principal terms of the merger must be approved by a *majority* in interest of each class of limited partners, unless a greater approval of limited partners is required by the partnership agreement. [Corps.C. § 15911.12(a)]

3) [8:210.4a] **LLCs:** The merger agreement must be approved by *all managers and a majority* in interest of each class of membership interests, unless a greater approval is required by the *operating agreement*. [Corps.C. § 17710.12(a); see Corps.C. § 17701.02(m) ("majority of the members" defined)]

4) [8:210.4b] **LLC members'/limited partners' unanimous consent to personal liability:** Approval of *all* limited partners or *all* LLC members (as the case may be) may be required where the merger results in *personal liability* of the limited partners or LLC members for any obligations of any constituent entity. [Corps.C. §§ 15911.12(a), 17710.12(a)]

5) [8:210.4c] **Merger with benefit corporation:** Where a noncorporate entity merges into a benefit corporation, or if the merger would have the effect of terminating the status of a corporation as a benefit corporation, the merger must be approved by the "minimum status vote" (ordinarily, at least *two-thirds* of every class or series of interest entitled to receive a distribution of any kind from the entity regardless of any otherwise applicable limitation on the voting rights of the interest). [Corps.C. §§ 14603(c), 14604(c); see Corps.C. § 14601(d)(2), ¶ *9:538 ff.*]

(b) [8:210.5] **Equal treatment of limited partners or members:** Certain restrictions apply in mergers with *any* LLC or with a partnership having *more than 35* limited partners.

In general, all limited partners of the same class, or all LLC members of the same class, must be treated equally with regard to any distribution of cash, property, securities and other interests, unless *all* limited partners or LLC members consent otherwise. Other restrictions apply where one constituent entity owns more than 50% (but less than 90%) of the voting securities of another constituent entity. All restrictions can be obviated by obtaining the approval of the Financial Protection and Innovation Commissioner. [See Corps.C. §§ 15911.12(b), 15911.13 (partnerships); Corps.C. § 17710.12(b) (LLCs)]

(c) [8:210.5a] **Shareholder's, partner's or LLC member's postmerger liability:** A shareholder of a *surviving* corporation, a partner of a *surviving* general or limited partnership, or a member of a *surviving* LLC is liable for:

• All obligations of a party to the merger for which that person was personally liable *before* the merger;

• All other obligations of the surviving entity incurred *before* the merger by a *party* to the merger, but those obligations may be satisfied only out of *property of the entity;* and

• All obligations of the surviving entity incurred *after* the merger, but those obligations may be satisfied only out of property of the entity where the person is a shareholder in a surviving corporation, a limited partner in a surviving limited partnership or, unless expressly provided otherwise in the articles of organization, a member in a surviving LLC. [Corps.C. §§ 1113(i)(4), 15911.16(d), 16914(c)]

1) [8:210.5b] **Special provision re general partners:** If the obligations incurred by a party before the merger are not satisfied out of the property of the surviving entity, the general partners of that party immediately before the merger (to the extent such party was a *general or limited partnership*) shall contribute the amount necessary to satisfy that party's obligations to the surviving entity in the same manner as if the party were dissolved. [Corps.C. § 16914(d)]

Additionally, the merger of a *limited* partnership into another business entity does not affect the liability that a general partner of a disappearing limited partnership may have in connection with the debts and liabilities of the disappearing limited partnership existing prior to the time the merger is effective. [Corps.C. § 15911.16(d)]

2) [8:210.5c] **Special provision re LLCs:** Nothing in the law governing LLCs is intended to affect the liability that a member of a disappearing LLC may have in connection with the debts and liabilities of the disappearing LLC existing prior to the time the merger is effective. [Corps.C. § 17710.16(d)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(d) [8:210.6] **Dissenters' rights:** Like dissenting shareholders, dissenting limited partners, LLC members or partners of a general partnership have the right to be *cashed out* for the value of their interests. [See Corps.C. §§ 15911.20 et seq. (limited partnerships), 17711.01 et seq. (LLCs), 16701 & 16914(e) (general partnerships)]

(2) [8:210.7] **Procedure to effect merger:** The procedure to effect a merger of one or more corporations with one or more noncorporate entities is essentially the same as in purely corporate mergers (*see ¶ 8:168 ff.*).

(a) [8:210.8] **Merger agreement:** The constituent entities must approve an *agreement of merger*, which must set forth:

• The names and places of organization of each constituent entity, and the identity of the surviving entity;

• The terms and conditions of the merger, including the manner by which shares of the corporation will be converted into shares, interests or other securities of the surviving entity, and any cash, property or other rights which the shareholders receive for their shares (or, if applicable, a statement that the shares are canceled without consideration);

• Any amendment to the surviving corporation's articles (if applicable) to be effected by the merger;

• Any other provisions required by the laws under which any constituent entity is organized; and

• Any other provisions desired by the parties, including a provision for the payment of cash in lieu of fractional shares or for any other arrangement consistent with Corps.C. § 407 (*see ¶ 8:170.7*). [Corps.C. § 1113(b)(1)-(6); see also Corps.C. § 3203(b)(1)-(6) (SPCs)]

1) [8:210.9] **Equal treatment for all shares of same class:** As in the case of a corporate merger, shares of the same class of the constituent corporation must generally be treated equally regarding any distribution of cash, property, rights or securities; *see ¶ 8:170.8 ff.* [Corps.C. § 1113(c); see also Corps.C. § 3203(c) (SPCs)]

2) [8:210.10] **Execution by corporation:** *See ¶ 8:171*. [Corps.C. § 1113(f); see also Corps.C. § 3203(f) (SPCs)]

(b) [8:210.11] **Approval by board of constituent corporation:** *See ¶ 8:172 ff.*

(c) [8:210.12] **Mergers proposed by insiders:** *See ¶ 8:172.5 ff.*

(d) [8:210.13] **Approval by shareholders:** In general, the constituent corporation is subject to the same shareholder approval requirements that apply in corporate mergers. *See ¶ 8:173 ff.* [Corps.C. § 1113(g); see also Corps.C. § 3203(g) (SPCs)]

1) [8:210.14] **No exception for mergers resulting in limited dilution:** While approval of voting shareholders is not required in corporate mergers where the shareholders retain more than 5/6ths of the voting power after the merger (*see ¶ 8:181 ff.*), in the case of a merger with a noncorporate entity as the *survivor*, approval by a majority of the constituent corporation's outstanding shares is required of each class that receives interests in the noncorporate entity … regardless of how little dilution of their voting power the shareholders may suffer. [Corps.C. § 1201(g)]

Such shareholders are also entitled to "dissenters' cash-out appraisal rights"; *see ¶ 8:292 ff.*

a) [8:210.14a] **Compare—two-thirds approval required for SPCs:** Similarly, approval of voting shareholders is not required in an SPC merger where the SPC shareholders retain more than 5/6ths of the voting power after the merger. However, in the case of such a merger with a noncorporate entity as the *survivor*, or where the survivor is an SPC whose articles specify a *materially different purpose*, the merger must be approved by at least *two-thirds* (or greater vote if required by the articles) of the outstanding shares of each class regardless of whether the articles entitle the class to vote on the merger. [Corps.C. § 3401(f)]

[8:210.14b - 8:210.14d] ***Reserved.***

2) [8:210.14e] **Unanimous consent required where shareholders become personally liable:** The merger must be approved by *all* shareholders of any class or series if, as a result of the merger, the holders of that class or series become *personally liable* for any obligations of a party to the merger. (But such unanimous consent is *not* required where all holders of the class or series have *dissenters' rights*, *¶ 8:292 ff.*) [Corps.C. § 1201(h); see also Corps.C. § 3401(g) (SPCs)]

3) [8:210.15] **"Controlled" merger—unanimous consent required where common shareholders receive other than common shares or noncorporate equity securities:** Where one constituent entity (or its parent) directly or

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

indirectly owns *more than 50%* of the voting power of a constituent corporation, the nonredeemable common shares of the corporation may be converted *only* into nonredeemable common shares of the surviving corporation (or a parent party as defined in Corps.C. § 1200(e)) or nonredeemable equity securities of the noncorporate survivor *unless all the holders of such common stock unanimously consent otherwise*. [Corps.C. § 1113(c); see also Corps.C. § 3203(c) (SPCs)]

a) [8:210.16] **Exception—Financial Protection and Innovation Commissioner approval:** Unanimous consent of the common shareholders (*¶ 8:210.15*) is *not* required where the Financial Protection and Innovation Commissioner approves the fairness of the merger terms and conditions in an interspecies merger after a fairness hearing. [Corps.C. § 1101.1; *see ¶ 8:177c*]

(e) [8:210.17] **Amendments to merger agreement; abandonment:** As in corporate mergers, the board of a constituent corporation may amend the merger agreement any time before the merger becomes effective; *see ¶ 8:184 ff.* [Corps.C. § 1113(d), (e); see also Corps.C. § 3203(d) (SPCs)]

Likewise, the board of a constituent corporation may abandon the merger any time before the merger becomes effective, subject to any resulting contractual liability to third parties and to other constituent entities; *see ¶ 8:186 ff.* [Corps.C. § 1113(e); see also Corps.C. § 3203(e) (SPCs)]

(f) [8:210.18] **Merger documents filed with Secretary of State:** After the requisite board and shareholder approvals (and approvals of the constituent entities), appropriate filings must be made with the Secretary of State.

1) [8:210.19] **Noncorporate entity as survivor:** If the surviving entity is a noncorporate entity and no public benefit corporation (Corps.C. § 5060), mutual benefit corporation (Corps.C. § 5059), religious corporation (Corps.C. § 5061) or corporation organized under the Consumer Cooperative Corporation Law (Corps.C. § 12200) is a party to the merger, a "certificate of merger" *on the form prescribed by the Secretary of State* must be filed. [Corps.C. § 1113(g)(2); see also Corps.C. § 3203(g)(2) (SPCs)]

FORM: The Secretary of State's standard form Certificate of Merger (OBE MERGER-1) is available online at the Secretary of State's website (*www.sos.ca.gov*).

a) [8:210.19a] **Execution of certificate:** The certificate of merger must be executed:

- on behalf of each constituent *corporation* by (i) the chairperson of the board, president or a vice president, and (ii) the secretary or an assistant secretary;

- on behalf of each constituent *general partnership* by *two* partners, unless the partnership agreement provides for a lesser number (but only *one* or more general partners need execute the certificate of merger on behalf of a *foreign* partnership);

- on behalf of each constituent *limited partnership* by *all* general partners, unless the certificate of limited partnership provides for a lesser number (but only *one* or more general partners need execute the certificate of merger on behalf of a *foreign* partnership);

- on behalf of each constituent *LLC* by *all* managers, unless a lesser number is specified in the articles of organization or operating agreement (but only *one* or more managers need execute the certificate on behalf of a *foreign* LLC); and

- on behalf of each *other form of constituent entity* by those persons required or authorized to execute the certificate by the laws under which that entity is organized, specifying the provision of law or other basis for the signing persons' authority. [Corps.C. § 1113(g)(2); see also Corps.C. § 3203(g)(2) (SPCs)]

b) [8:210.19b] **Additional information permitted on form:** In addition to the information contained on the printed form, the certificate of merger must set forth any other information required by the laws under which any noncorporate constituent entity was organized. [Corps.C. § 1113(g)(1) & (2); see also Corps.C. § 3203(g)(1) & (2) (SPCs)]

2) [8:210.20] **Corporation as surviving entity:** If the surviving entity is a corporation (including an SPC or benefit corporation), or if a public benefit corporation (Corps.C. § 5060), mutual benefit corporation (Corps.C. § 5059), religious corporation (Corps.C. § 5061) or corporation organized under the Consumer Cooperative Corporation Law

(Corps.C. § 12200) is a party to the merger, the same filing requirements apply as in corporate mergers—i.e., filing a copy of the *agreement of merger*, accompanied by an *officers' certificate* of each constituent *corporation* (*see ¶ 8:189 ff.*).

Also, the "*certificate of merger*" (*¶ 8:210.19 ff.*) must be filed for each disappearing *noncorporate entity*. [Corps.C. § 1113(g)(1); see also Corps.C. § 3203(g)(1) (SPCs)]

3) [8:210.21] **Filing fee:** The fee for filing documents merging one or more corporations with one or more noncorporate entities is $150. [Gov.C. § 12186(*l*)]

(3) [8:210.22] **Effect of merger:** Unless a future date or time is specified in the certificate of merger (per Corps.C. § 110(c)), the merger is effective upon filing with the Secretary of State in the same manner as with corporate mergers. And it has the same legal effect (i.e., survivor succeeds to the assets and liabilities of the disappearing entity; *see ¶ 8:191 ff.*). [Corps.C. § 1113(g) & (i); see also Corps.C. § 3203(g) & (i) (SPCs)]

(4) [8:210.23] **Dissenting shareholders' rights:** Shareholders who were entitled to vote on the merger and who opposed it have the right to be cashed out for the appraised value of their shares. (*See ¶ 8:292 ff.* for detailed discussion of dissenters' rights.) [Corps.C. § 1300]

[8:210.24 - 8:210.25] ***Reserved.***

f. [8:210.26] **Compare—mergers with *foreign entities:*** Interstate mergers (i.e., mergers between domestic (California) and *foreign* corporations or noncorporate entities) involve some of the same requirements applicable to strictly domestic mergers so as to protect the constituent California corporation's shareholders, as discussed below (¶ 8:210.27 ff.). Of course, somewhat different procedures necessarily apply to interstate mergers, depending on whether the California or foreign entity is the *survivor*.

• **Caveat—tax-free treatment generally unavailable in mergers with *noncorporate* entities:** *See ¶ 8:210.1a*.

(1) [8:210.27] **Shareholders' rights (California corporation):** The requirements of equal treatment of shares of the same class (*¶ 8:170.8*), fair treatment of fractional share interests (*¶ 8:170.7*), board and shareholder approvals (*¶ 8:172 ff., 8:173 ff.*), and dissenters' rights (*¶ 8:292 ff.*) all apply to protect California corporation shareholders in mergers with foreign entities. [Corps.C. §§ 1108(b), (f), 1113(j)(2); see also Corps.C. § 3203(j)(2) (SPCs)]

(2) [8:210.28] **California corporation as survivor:** If a California corporation is the surviving entity, the merger procedures are essentially the same as in a merger of domestic entities:

• The agreement of merger (*¶ 8:189, 8:210.8*) or certificate of ownership in "short-form" corporate mergers (*¶ 8:199*) must be filed; and

• Attached to the agreement of merger must be an officers' certificate for each constituent corporation (*¶ 8:189*) and the appropriate certificate of merger for any noncorporate constituent entities (*¶ 8:210.19 ff.*).

(a) [8:210.29] **When merger effective:** Upon *filing* of the appropriate documents, the merger is effective as to each constituent California entity (unless a delayed effective date is set forth in the filing pursuant to Corps.C. § 110(c)). [Corps.C. §§ 1108(c), 1113(j)(3); see also Corps.C. § 3203(g)(2), (j)(3) (SPCs)]

(3) [8:210.30] **Foreign entity as survivor:** If the survivor is a foreign entity, the merger proceedings may be in accordance with, and governed by, the law of the jurisdiction in which the foreign entity is organized (subject to specifically-applicable requirements of California law for the protection of domestic corporation shareholders, *¶ 8:210.27*). [Corps.C. §§ 1108(b), (f), 1113(j)(2); see also Corps.C. § 3203(j)(2) (SPCs)]

(a) [8:210.31] **When merger effective:** The merger with a surviving foreign entity is effective as to any disappearing California corporation at the time of effectiveness in the foreign jurisdiction, but only when appropriate documentation is *filed* with the California Secretary of State. [Corps.C. §§ 1108(d), 1113(j)(4); see also Corps.C. § 3203(j)(4) (SPCs)]

Where the merger involves a noncorporate entity and the survivor is a foreign entity, the appropriate documentation to be filed consists of a copy of the agreement of merger, with an officers' certificate of each constituent corporation, and the appropriate certificate of merger of any noncorporate constituent entities (*¶ 8:210.19 ff.*). [Corps.C. § 1113(j)(4); see also Corps.C. § 3203(j)(4) (SPCs)]

Where only corporations are involved, the appropriate documentation consists of *any one* of the following:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- A copy of the agreement, certificate or other document filed by the survivor in its jurisdiction of incorporation to effectuate the merger, as *certified* by the public official having custody of the original (a file-stamped copy of the document is not adequate); or

- An executed counterpart of the agreement, certificate or other document filed in the foreign jurisdiction to effectuate the merger; or

- A copy of the agreement of merger with an officers' certificate (¶ *8:189*) of the surviving foreign corporation and of each constituent California corporation; or

- A certificate of ownership (¶ *8:199*) in the case of a "*short-form*" merger. [Corps.C. § 1108(d)(1)-(4)]

1) [8:210.32] **Exception—delayed California filing:** If the California filing occurs *more than six months* after the merger's effective date in the foreign jurisdiction (or the California corporation's powers are suspended on such date), the merger becomes effective as to any disappearing California corporation only at such time as the required filing (¶ 8:210.31) is made in this state. [Corps.C. §§ 1108(e), 1113(j)(5); see also Corps.C. § 3203(j)(5) (SPCs)]

(4) [8:210.33] **Effect on disappearing foreign entities:** Effective upon filing of the merger documents in California (or upon such later effective date as may be set forth in the merger documents pursuant to Corps.C. § 110(c), ¶ 8:190.1), any disappearing foreign corporation qualified to transact intrastate business automatically surrenders its right to do so, and any disappearing foreign noncorporate entity registered in California cancels its certificate of registration. [Corps.C. §§ 1108(c), (e), 1113(j)(6); see also Corps.C. § 3203(j)(6) (SPCs)]

(a) [8:210.34] **Exception—delayed California filing:** If the filing in California occurs *more than six months* after the merger's effective date in the foreign jurisdiction, a disappearing foreign *corporation* qualified to transact intrastate business automatically surrenders its right to transact intrastate business as of the date of the *filing* in California. [Corps.C. § 1108(e); *see* ¶ *8:210.32*]

g. [8:211] **Tax consequences ("A reorganizations"):** Statutory mergers and consolidations are called "A reorganizations" because they are the first of the seven types of corporate reorganizations listed in IRC § 368(a)(1)(A)-(G).

(1) [8:212] **Straight merger:** Subject to qualifications noted below (¶ 8:213 ff.), a straight merger (in which the security holders of the disappearing corporation receive securities of the survivor; ¶ *8:164*) is a *tax-free* exchange. [IRC § 354(a)(1)]

Unlike the "B" and "C" reorganizations discussed below (¶ 8:244 ff.), no particular type or class of stock is required to be received by the shareholders of the disappearing corporation. (The survivor may issue them preferred or common, voting or nonvoting shares, or, subject to the "continuity of interest requirement" for tax-free treatment (¶ *8:215 ff.*), even debt securities or cash or other property.)

(a) [8:213] **Basis carryovers:** The survivor takes the disappearing corporation's tax basis in the assets acquired from the disappearing corporation. [IRC § 362(b)]

The shareholders of the disappearing corporation retain the same basis in the stock or securities received in the merger as in the stock or securities surrendered. (The carryover basis is adjusted for receipt of "boot" or dividends.) [See IRC § 358(a)(1)]

(b) [8:214] **Taxability of "boot":** Any cash or other property received in addition to the exchange of securities is currently taxable as "boot." [IRC § 356(a)(1)]

As a general rule, "boot" is treated as gain from the sale or exchange of property (i.e., *capital gain*). However, if the "boot" has the "effect of the distribution of a dividend," the gain recognized will be taxed as a *dividend* to the extent of the shareholder's ratable share of the corporation's earnings and profits (*see* ¶ *7:177 ff.*). [IRC § 356(a)(2)]

1) [8:214.1] **"Postreorganization" approach:** In determining whether the "boot" has the "effect of the distribution of a dividend," the U.S. Supreme Court has held that the stock-for-stock exchange must be viewed as an *integrated whole*, rather than examining the "boot" payment in isolation.

Under this analysis, the "boot" is treated as a *postreorganization stock redemption* subject to the "substantially disproportionate" redemption test of IRC § 302 (*see* ¶ *7:234 ff.*). Thus, if the hypothetical redemption falls within any one of the four categories set out in § 302 (i.e., there is a meaningful reduction in the taxpayer's ownership interest), the "boot" is treated as capital gain and not dividend income. [*Commissioner of Internal Revenue v. Clark*

(1989) 489 US 726, 729, 109 S.Ct. 1455, 1458—cash payment received in merger treated as capital gain where taxpayer gave up more than 20% of his holdings and retained less than 1% voting interest after merger]

2) [8:214.2] **"Nonqualified preferred stock" as "boot":** "Nonqualified preferred stock" (*¶ 3:340.1 ff.*) received in a merger is treated as "boot" (unless received in exchange for other "nonqualified preferred stock"). [IRC §§ 354(a)(2)(C)(i), 356(e)]

(c) [8:215] **Continuity of interest requirement:** Tax-free treatment applies only if the disappearing corporation's shareholders (i.e., the transferring shareholders) retain a *continuing proprietary interest* in the survivor corporation. [Treas.Reg. § 1.368-1(b); see *LeTulle v. Scofield* (1940) 308 US 415, 420-421, 60 S.Ct. 313, 316; *J.E. Seagram Corp. v. Commr.* (1995) 104 TC 75, 99-100]

1) [8:216] **Must be stock or stock rights:** Transfers in which the shareholders receive only stock or stock rights (i.e., warrants or options) in return for stock in the acquiring corporation clearly qualify. (The stock may be either common or preferred, voting or nonvoting … provided it is nonredeemable.) [*Le Tulle v. Scofield* (1940) 308 US 415, 420-421, 60 S.Ct. 313, 316]

a) [8:216.1] **Caution—"nonqualified preferred" probably not acceptable:** "Nonqualified preferred stock" *probably would not* satisfy the "continuity of interest" requirement, because:

• By definition, it does *not participate in corporate growth* to any significant extent; and

• For many purposes, it is treated as the functional equivalent of debt, and debt does *not* satisfy the "continuity of interest" requirement (*see ¶ 8:217*). [See IRC §§ 351(g)(2)(A) & (3), 354(a)(2)(C); *and ¶ 3:340.1 ff.*]

b) [8:217] **Debt:** Transfers of stock for debt do not satisfy the continuity of interest requirement: The transferor no longer has the same proprietary interest in the surviving corporation that the transferor had in the disappearing corporation. [Treas.Reg. § 1.354-1(d); *Roebling v. Commr.* (3rd Cir. 1944) 143 F2d 810, 814]

c) [8:218] **Stock exchanged for combination of stock, debt and/or cash:** If *both* stock and debt securities (or stock and cash) are received in return for stock, the exchange will be tax-free as to the stock, provided the stock constitutes a "substantial part" of the consideration received in the exchange. Although "substantial part" is not defined, stock having a value of *at least 50%* of the total consideration would be deemed "substantial." (The debt securities will be taxable as "boot" along with any cash or other property received.) [Treas.Reg. § 1.368-1(e)(1) & (6), ex. 1]

d) [8:218.1] **Compare—debt exchanged for debt:** Some mergers may involve an exchange of stock for stock *and debt for debt* (e.g., bondholders in the disappearing corporation receive new bonds in the surviving corporation). The debt-for-debt exchange will not violate the continuity of interest requirement so long as:

— all debt instruments involved in the exchange constitute "*securities*" (generally, a term of at least *five years* is required); *and*

— the debt securities received in the exchange represent a continuation of the debtholders' investment *in substantially the same form*. [See Rev.Rul. 2004-78, 2004-2 CB 108]

e) [8:218.2] **Compare—debt exchanged for stock:** Creditors are deemed to have a *proprietary* interest in an *insolvent* disappearing corporation; hence, the continuity of interest requirement may be satisfied where the creditors receive stock in the survivor corporation in exchange for their debt interests. [Treas.Reg. § 1.368-1(e)(6)]

[8:218.3 - 8:218.4] *Reserved.*

2) [8:218.5] **Sale of interest:** The disappearing corporation's shareholders can sell their proprietary interest without jeopardizing the "continuity of interest" test so long as the sale is to *third parties* and not back to the acquiring corporation. [Treas.Reg. § 1.368-1(e)(1); compare Rev.Rul. 99-58, 1999-2 CB 701—publicly-held corporation's market purchases of same number of shares previously issued in merger did not jeopardize continuity of interest where purchases made to avoid dilution and not as part of merger plan]

(Under prior law, an exchange of securities followed by a resale that had been planned at the time of the merger could, under the step transaction doctrine, be considered tantamount to a cash sale, causing the exchange to fail

the "continuity of interest" test. See, e.g., *McDonald's Restaurants of Ill., Inc. v. Commr.* (7th Cir. 1982) 688 F2d 520, 525-527.)

[8:218.6 - 8:218.9] ***Reserved.***

(d) [8:218.10] **Continuity of business requirement:** Tax-free treatment also requires that the surviving corporation either continue the disappearing corporation's *historic business* (generally, the business it conducted most recently) or use a *significant portion* of the disappearing corporation's historic business assets. Where the disappearing corporation had more than one line of business, the surviving corporation need continue only *a significant line of business*. [Treas.Reg. § 1.368-1(d); see *Berry Petroleum Co. v. Commr.* (1995) 104 TC 584, 635-636, aff'd (9th Cir. 1998) 142 F3d 442; *Honbarrier v. Commr.* (2000) 115 TC 300, 312-315]

1) [8:218.11] **Merger coupled with partial asset sale:** For various reasons, the surviving corporation may not want all of the disappearing corporation's operating assets. Fortunately, the surviving corporation may, as part of the merger plan, sell a substantial portion (even as much as half) of the assets to an unrelated third party without violating the continuity of business requirement … so long as the survivor *continues to hold the sale proceeds* along with its other operating assets. [See Rev.Rul. 2001-25, 2001-1 CB 1291; Rev.Rul. 2008-25, 2008-1 CB 986 (clarifying application of step-transaction doctrine to tax-free reorganizations)]

(2) [8:219] **Triangular mergers:** The above rules also generally apply to triangular mergers (in which the acquired "target" corporation is merged into a subsidiary of the acquiring corporation, *see ¶ 8:165*). [IRC § 368(a)(2)(D); see Rev.Rul. 2001-24, 2001-1 CB 1290—subsidiary's stock may be transferred to "sister" corporation as part of merger plan (i.e., target effectively becomes subsidiary of acquiring corporation's subsidiary) and still qualify as tax-free "A" reorganization]

(a) [8:219.1] **Merger into noncorporate entity permitted:** A triangular merger in which the acquired "target" corporation is merged into a *noncorporate* entity that is wholly owned by the acquiring corporation will qualify for tax-free treatment (so long as the merger otherwise complies with the above rules, ¶ 8:212 ff.). In such circumstances, the transaction is tantamount to a merger with the acquiring corporation because, for tax purposes, the noncorporate "single-member" entity is not regarded as separate from the acquiring corporation. [Treas.Reg. § 1.368-2(b)(1)(i), (iii), exs. 2, 4 & 11; *see ¶ 8:210.1a*]

(3) [8:220] **Reverse triangular mergers:** The same rules apply to reverse triangular mergers (*¶ 8:166*), but with two limitations:

• [8:221] *Control*—i.e., at least 80% of the total combined voting shares *plus* at least 80% of all other classes of shares of the target corporation—must be acquired *solely* in exchange for voting stock of the acquiring (parent) corporation. (The remaining shares of the target corporation's stock may be acquired for cash, property or other securities.) [IRC § 368(c) & (a)(2)(E)(ii)]

• [8:222] After the merger, the target corporation (now a controlled subsidiary of the acquiring corporation) must *retain* intact "substantially all of its properties" and those of the disappearing former subsidiary (used by the parent corporation for the acquisition, *¶ 8:166*). [IRC § 368(a)(2)(E)(i)] (The term "substantially all" has the same meaning here as in a type "C" reorganization; *see ¶ 8:277*.)

(4) [8:222.1] **Mergers of 80%-owned subsidiaries:** Where a subsidiary is merged into a parent owning 80% or more of its stock, the transaction is treated for tax purposes as a tax-free *liquidation* instead of a tax-free reorganization. [IRC § 332(b); *¶ 8:1166 ff.*]

(5) [8:223] **Advantage of merger ("A reorganization") over stock-for-stock exchange ("B reorganization"):** As discussed below (¶ 8:244 ff.), a stock-for-stock exchange ("B reorganization") is tax-free only if stock is exchanged *solely* for voting stock in the acquiring corporation. If any other consideration is paid to *any* exchanging shareholder, the exchange is taxable to all (even to those who received only voting stock in the acquiring corporation; *see ¶ 8:246*).

Thus, any form of statutory merger or consolidation—even the reverse triangular form, with its limitations (¶ 8:220 ff.)—is more flexible than the stock-for-stock exchange for reorganization purposes, as it allows use of cash, debt or property (i.e., other than voting stock).

(a) [8:224] **Example:** Parent Corp. wants to acquire all of the stock of Target Corp. It is desirable that Target's legal identity be preserved. Target is owned 80% by X, and 20% by Y. X insists on a tax-free exchange, but Y wants to be cashed out or to receive notes for his stock.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

If Parent issues stock to X in exchange for his Target stock, and purchases Y's shares for cash, the transaction is fully taxable to *both* of them. (It is not a tax-free "B reorganization" because not "solely" in exchange for voting stock.)

But the parties' objectives can be accommodated through a *reverse triangular merger* (*¶ 8:166*): i.e., Parent forms Subsidiary, and capitalizes it with enough of its voting stock to acquire X's shares and enough cash or notes to buy Y's shares in Target. Subsidiary is then merged into Target (whereby Parent receives voting control of Target). Parent then causes Target to use the cash or notes acquired from Subsidiary to purchase Y's shares and to exchange its voting stock in Parent for X's shares. The transaction is tax-free to X, even though Y was cashed out as part of the merger.

(b) [8:225] **Further example:** Suppose Y owned 25% of Target's stock, rather than just 20%. In this case, a reverse triangular merger would *not* be tax-free … because of the special requirement that at least 80% of all voting stock of all other classes of the corporation be exchanged for voting stock in the acquiring corporation (*¶ 8:221*).

But a straight merger or triangular merger could still be utilized, since neither is subject to the 80% requirement. (Utilizing these forms of merger, however, would sacrifice the goal of preserving Target's legal identity; *see ¶ 8:166*.)

h. Securities laws considerations

(1) [8:226] **Federal securities laws:** Various provisions of federal securities laws may apply to a statutory merger or consolidation:

(a) [8:227] **Proxy rules** (SEA § 14 and SEC Reg. 14A), where shareholder approvals or consents are required for a corporation subject to the 1934 Act reporting requirements.

(b) [8:228] **Registration requirements** of the 1933 Act, since, in voting on the merger, shareholders are in effect being asked to make a new investment decision; i.e., whether to accept new and different securities in exchange for their existing securities. [SEC Rule 145]

(Of course, most of the *exemptions* from registration would potentially be available, including SA § 4(a)(2) and Regulation D, *¶ 5:107 ff.*; and SA § 3(a)(10) if California qualification is obtained upon a "fairness hearing," *¶ 5:194.1 ff.* Also, the *preemption* provisions of the 1933 Act (*¶ 5:18.5 ff.*) may apply.)

(c) [8:229] **Antifraud rules** (SEA § 10(b)and SEC Rule 10b-5) apply whether or not the securities are registered under federal law; transferring shareholders are covered as "purchasers" of the acquiring corporation's securities (and as involuntary or forced "sellers" if they exercise their dissenters' rights to be cashed out; *see ¶ 6:372.2*).

(2) [8:230] **California Corporate Securities Law:** Negotiations and agreements leading up to a merger, prior to soliciting approval by the holders of equity securities, are specifically exempt from qualification. [Corps.C. § 25103(a)]

However, once shareholder approval is sought, qualification is required (unless federally preempted; *see ¶ 5:18.5 ff.*). It is unlawful to *offer to exchange stock or securities* incident to a merger or consolidation (or other form of reorganization) unless the securities are qualified by permit or an exemption is available. [Corps.C. §§ 25120, 25121]

(This would *not* apply to mergers where the minority is entirely cashed out, or where a wholly-owned subsidiary is merged into its parent, where *no issuance or exchange of securities* is involved; *see ¶ 8:206*.)

(a) [8:231] **"Nonresidents" exemption:** A principal exemption for merger transactions is the "nonresidents" exemption (also applicable to sale-of-assets reorganizations, ¶ 8:289.1), which basically exempts an issuance or exchange of securities incident to a merger where *less than 25%* of the *outstanding* shares of any class being exchanged are held by California residents. [Corps.C. § 25103(c), (d)]

For purposes of this exemption, shares are *not* considered "outstanding" if they are known by the issuer to be held in the names of broker-dealers (or their nominees), or are held by any person controlling 50% or more of the class. [Corps.C. § 25103(d)(1), (2)]

1) [8:232] **Distinguish—other recapitalization exemptions inapplicable:** The other major statutory exemptions available for *recapitalizations* (Corps.C. § 25103(b), (e), (f), (g); *see ¶ 8:90 ff.*) do *not* apply to mergers.

In particular, note that the Corps.C. § 25102(f) "limited offering" exemption and the Corps.C. § 25102(n) "qualified purchaser" exemption, which may be available for recapitalizations (*see ¶ 8:156*), are *not* likewise available for mergers. [Commr. Rule 260.103]

(b) [8:232.1] **"Limited exchange transaction" exemption:** Also applicable to mergers (other than certain proscribed rollups; see Corps.C. § 25014.6) is the so-called "limited exchange transaction" exemption, which exempts issuances of

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

any securities incident to a merger (or sale of assets, *¶ 8:289.2*) if the issuance *satisfies the conditions of the § 25102(f) "limited offering exemption"* (*¶ 5:256 ff.*) *and either*:

• [8:232.2] **Shareholder approval:** The transaction is approved by at least *75%* of the outstanding equity securities of each constituent entity entitled to vote on the transaction, not more than *10%* of such securities vote against it, and each entity whose security holders are entitled to vote on the transaction is subject to a state statute providing dissenters' rights to equity security holders not approving the transaction;

OR

• [8:232.3] **Merger solely to change form or domicile:** The sole purpose of the transaction is to change the issuer's state or form of organization, all security holders of the same class or series are treated equally (unless they all consent otherwise), and the holders of nonredeemable voting equity securities receive only nonredeemable voting equity securities. [Corps.C. § 25103(h)(1)(A) & (B)]

1) [8:232.4] **Notice of transaction:** The acquiring or surviving entity must file a notice of transaction with the Financial Protection and Innovation Commissioner within *15 calendar days* after the first sale of the securities in California, and must pay a $600 filing fee. [Corps.C. §§ 25103(h)(2), 25608(z); Commr. Rule 260.103.6]

As with the other limited offering exemptions, failure to file the notice will not affect the exemption's availability. However, an acquiring entity that fails to file the notice as required by the Commissioner's Rule, must, within 15 business days after demand by the Commissioner, file the notice and pay a fee equal to that payable to qualify the transaction (see Corps.C. § 25608). [Corps.C. § 25103(h)]

• ***FORM:*** The Commissioner's form, Notice of Exchange Transaction or Entity Conversion Pursuant to Corporations Code Section 25103(h) (Form DBO-260.103.6(b)), is available online at the Department of Financial Protection and Innovation website (*www.dfpi.ca.gov*).

a) [8:232.5] **Where to file:** The notice may be filed in the Los Angeles office of the Department of Financial Protection and Innovation's Division of Corporations: 320 West 4th St., Suite 750, Los Angeles, CA 90013-2344. [Commr.Rel.No. 13-G (revised 2004)]

The notice may also be filed online, and the filing fee paid by credit card, at the Department's Self Service Portal (*https://docqnet.dfpi.ca.gov/*).

[8:232.6 - 8:232.9] ***Reserved.***

(c) [8:232.10] **Exchanges approved by bankruptcy court:** Also exempt from qualification is any exchange of securities in connection with any merger, consolidation or sale of corporate assets in consideration wholly or in part of the issuance of securities pursuant to a plan of reorganization or arrangement that is confirmed (or subject to confirmation) by a court pursuant to the U.S. Bankruptcy Code. [Corps.C. § 25103(i); Commr. Rule 260.103(a)(2); see Corps.C. § 25017(f)(3)]

(Securities issued upon bankruptcy court approval are likewise exempt from federal registration; *see ¶ 5:194.11.*)

(d) [8:233] **Commissioner's standards re granting permit:** If no exemption is available, the exchange will have to be qualified in accordance with the procedure discussed in connection with recapitalizations (*see ¶ 8:157*).

The Commissioner's Rules require that any plan combining two or more corporations by way of merger or consolidation "should provide for the issuance of securities which *fairly reflect the relative values* of the corporations which are parties to the plan …" [Commr. Rule 260.140.61]

➪ [8:233.1] ***PRACTICE POINTER:*** Whether exempt or not, it may be desirable to qualify the merger issuance on a requested *fairness hearing*. This will allow the issuance of any securities in connection with the merger to be exempt from federal registration. [SA § 3(a)(10), *¶ 5:194.1 ff.*]

(e) [8:234] **Soliciting shareholder approval:** If a permit is required, shareholder approval may not be sought until *after* such permit has been granted. Whatever materials are distributed to the shareholders must be submitted in advance to the Financial Protection and Innovation Commissioner (usually by attaching same as an exhibit to the application for permit). [Commr. Rule 260.140.60]

4. [8:235] **Exchange Reorganizations (Stock-for-Stock):** The most direct method for one corporation to acquire control of another is an "exchange reorganization": The acquiring corporation simply issues some of its own (or a parent corporation's)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

equity securities in *exchange*, in whole or in part, for a controlling interest in the target corporation. ("Control" means ownership, directly or indirectly, of more than 50% of the corporation's voting shares; Corps.C. § 160(b).) [Corps.C. § 181(b); see also Corps.C. § 2511(b) (SPCs)]

No merger or consolidation of the two corporations is effected thereby. Rather, the acquired corporation simply becomes a *subsidiary* of the acquiring corporation.

• [8:235.1] ***Compare*—share exchange *not resulting in controlling interest:*** An exchange of shares whereby *less than a controlling interest* in the target company is acquired is *not* an "exchange reorganization" (Corps.C. § 181(b); see also Corps.C. § 2511(b) (SPCs)); rather, it is a "share exchange tender offer" (Corps.C. § 183.5; see also Corps.C. § 2512 (SPCs)). While both types of transactions are subject to similar shareholder approval requirements (¶ 8:238 ff.) and special "interested party proposal" procedures (¶ 8:237.1 ff.), "dissenters' rights" are available *only* in connection with "reorganizations" (¶ 8:293.2)—*not* pursuant to share exchange tender offers.

• [8:235.2] ***Compare—equity exchange with noncorporate entity:*** A corporation may also use an "exchange reorganization" to acquire control of a *noncorporate* entity (e.g., limited partnership or LLC) by issuing the corporation's (or a parent entity's) equity securities in exchange, in whole or in part, for equity securities that give the corporation more than 50% of the voting power of the noncorporate entity. (Similarly, a noncorporate entity may use an exchange reorganization to acquire control of a corporation by issuing equity securities of the noncorporate entity (or its parent) in exchange for shares constituting more than 50% of the voting power of the corporation.) Here again, dissenting shareholders have the right to be "cashed out" (¶ 8:242). [Corps.C. §§ 160(b), 168, 181(b); see also Corps.C. § 2511(b) (SPCs)]

However, an exchange reorganization with a noncorporate entity does *not* qualify as a tax-free "B reorganization" (IRC § 368(a)(1)(B), ¶ *8:244 ff.*). For this reason, the remainder of this discussion focuses on purely corporate exchange reorganizations.

a. Procedure

(1) [8:236] **Tender offer by acquiring corporation:** The first step in an exchange reorganization (or "share exchange tender offer") normally is for the board of directors of the acquiring corporation to authorize an "exchange tender offer" to the holders of the voting stock of the target corporation. [Corps.C. § 1200(b), (d); see also Corps.C. § 3400(b), (d) (SPCs, ¶ *9:315*)]

(a) [8:237] **Terms:** In an exchange reorganization, the offer typically provides that the acquiring corporation will issue a certain number of its equity shares (common, preferred or a combination) in exchange for *controlling* (more than 50%) voting shares of the target corporation. A payment of cash, debt securities or other property to the target corporation's shareholders may also be included (but if so, the exchange will not be tax-free; *see* ¶ *8:244 ff.*). The offer usually will also provide that the offeror corporation is not obligated to purchase any shares unless enough are tendered to transfer control of the target corporation.

(2) [8:237.1] **Offer made by insider:** If the exchange reorganization tender offer (or "share exchange tender offer," *see* ¶ *8:235.1*) is proposed by an *insider*—i.e., an "interested party"—special requirements are imposed to ensure that the shareholders will be treated fairly in the non-arm's-length transaction.

(a) [8:237.2] **Who is an "interested party":** The special requirements apply to exchange offers made to a corporation by anyone who:

• Directly or indirectly *controls* the corporation;

• Is directly or indirectly controlled by any of the corporation's officers or directors; or

• Is an entity in which any of the corporation's directors or "executive officers" (i.e., president, vice-president, or other persons serving similar policymaking functions) holds a *material financial interest*. [Corps.C. § 1203(a)]

1) [8:237.3] **Exception—corporations with fewer than 100 shareholders:** The special requirements do not apply where the proposal is made to a corporation with *fewer than 100* shareholders of record. [Corps.C. § 1203(a) (last para.)]

2) [8:237.4] **Exception—exchange qualified by permit:** Nor do the special requirements apply to an exchange transaction that has been qualified by permit from the Financial Protection and Innovation Commissioner. [Corps.C. § 1203(a) (last para.)]

(b) [8:237.5] **Independent fairness opinion:** The interested party proposing the stock-for-stock exchange must provide the shareholders with an independent written opinion as to the fairness of the consideration they will receive in the transaction. [Corps.C. § 1203(a)]

1) [8:237.6] **Delivery of opinion:** Ordinarily, the fairness opinion must be delivered to the shareholders when the exchange offer is first made in writing to them. However, if the exchange offer is commenced by *publication* and offering materials are subsequently sent to the target shareholders, the opinion may be included in those offering materials. [Corps.C. § 1203(a)(2)]

2) [8:237.6a] **Opining person's qualifications:** *See ¶ 8:172.10*.

(c) [8:237.7] **Competing offers:** The board of directors must notify the shareholders of any competing offer requiring shareholder acceptance or approval made at least 10 days before the interested party proposal is to be approved, whether a tender offer, a merger offer, a stock-for-stock exchange (*¶ 8:235 ff.*), a sale-of-assets reorganization (*¶ 8:259 ff.*) or a straight sale-of-assets (*¶ 8:581 ff.*). The directors must also forward to the shareholders any written materials provided by the later offeror (at such offeror's expense). [Corps.C. § 1203(b)(1)]

1) [8:237.8] **Insider proposal delayed pending shareholder action on competing offer:** The interested party must delay completion of the exchange transaction for at least 10 days after notice to the shareholders of the competing offer. The purpose is to give the shareholders a reasonable opportunity to withdraw their acceptance and any tendered shares. [Corps.C. § 1203(b)(2)]

2) [8:237.8a] **Improving insider offer:** *See ¶ 8:172.14*.

➪ [8:237.9] ***PRACTICE POINTER:*** When an insider proposal is submitted to the shareholders for approval, the corporation should disclose that competing offers received at least 10 days before the proposal is approved also will be submitted for shareholder consideration.

(3) [8:238] **Shareholder approval by acquiring corporation:** Except as noted below (*¶ 8:238.3 ff.*), the principal terms of the exchange must be approved by a majority of the outstanding shares of each class of the *acquiring* corporation (or of its controlling parent whose equity securities are being issued), or any greater percentage required by its articles. (Approval by the target corporation's board of directors or shareholders is not required because the offer is being made individually to the shareholders.) [Corps.C. §§ 1200(b) & (d), 1201(a), 1201.5(a)]

(a) [8:238.1] **Measuring shareholder approval:** *See ¶ 8:173*.

1) [8:238.1a] **Foreign corporation shareholder approval:** *See ¶ 8:177.3*.

(b) [8:238.2] **Before or after board approval:** *See ¶ 8:173.1*.

(c) [8:238.3] **Exception—share exchanges involving SPCs (two-thirds approval required):** Approval by at least *two-thirds* (unless the articles set forth a greater vote) of each class of the outstanding shares is required if the disappearing corporation is *not an SPC* and the shareholders receive shares of a surviving *SPC*. [Corps.C. § 1201(f)]

Similarly, approval by at least *two-thirds* (unless the articles set forth a greater vote) of each class of the outstanding shares is required if shareholders of a disappearing *SPC* receive shares of a surviving corporation that is *not an SPC*, or if shareholders of a disappearing SPC receive shares of a surviving *SPC* whose articles specify a *materially different purpose*. Such two-thirds approval is required regardless of whether the articles entitle the class to vote on the transaction. [Corps.C. § 3401(f)]

(d) [8:238.4] **Exception—share exchanges involving benefit corporations (two-thirds approval required):** Where the acquired corporation is not a benefit corporation and the articles of the acquired corporation are to be amended in the exchange reorganization to provide that it will be a benefit corporation, the reorganization must be approved by at least *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class or series of stock of the *acquired corporation* regardless of any limitation in the articles or bylaws on the voting rights of any class or series. [Corps.C. § 14603(b); see Corps.C. § 14601(d)(1), *¶ 9:537*]

Conversely, if the exchange reorganization would have the effect of terminating the status of a corporation as a benefit corporation, the reorganization must be approved by at least *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class or series of stock of the *benefit corporation* regardless of any limitation stated

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

in the articles or bylaws on the voting rights of any class or series. [Corps.C. § 14604(b); see Corps.C. § 14601(d)(1), *¶ 9:537*]

(e) [8:239] **Exceptions—share exchanges NOT requiring shareholder approval:** Unless the articles provide otherwise, the acquiring corporation's (or its parent's) shareholders need *not* approve a share exchange in the following cases:

1) [8:240] **Preferred shares unaffected by share exchange:** Approval is not required by nonvoting *preferred* shareholders if their rights are not affected by the proposed issuance (e.g., in the typical case where only common shares are being issued). [Corps.C. §§ 1201(a), 1201.5(a); see also Corps.C. § 3401(a) (SPCs); *and ¶ 8:179*]

2) [8:241] **Exchanges resulting in limited dilution of voting power:** Nor is shareholder approval required where the share exchange transaction results in only a limited dilution of the voting power of the acquiring corporation's shareholders. [Corps.C. §§ 1201(b), 1201.5(b); see also Corps.C. § 3401(b) (SPCs); *and discussion of "limited dilution test," ¶ 8:181 ff.*]

a) [8:241.1] **Limitation—articles amendment required:** Regardless of limited dilution, shareholder approval may still be required if an articles amendment is necessary to effect the share exchange. [Corps.C. §§ 902(a), 903; *see ¶ 8:52 ff.*]

b) [8:241.2] **Limitation—disappearing close corporation:** Likewise, regardless of limited dilution, shareholder approval (ordinarily, by two-thirds vote) is required in an exchange *reorganization* where, through issuance of additional shares, the acquiring corporation loses its status as a statutory close corporation. [Corps.C. § 1201(e); see also Corps.C. § 3401(e) (SPCs); *and ¶ 8:176*]

(f) [8:242] **Dissenters' rights:** In an exchange *reorganization* (but *not* a "share exchange tender offer," *¶ 8:235.1*), shareholders of the acquiring corporation whose approval is required and who dissent from the exchange are entitled to be cashed out at the appraised value of their shares. (See detailed discussion of dissenters' rights at *¶ 8:292 ff.*)

(4) [8:243] **Abandonment:** The board of directors of the acquiring corporation can abandon the proposed exchange even after it has been approved by its shareholders. [Corps.C. § 1201(i); see also Corps.C. § 3401(h) (SPCs)]

However, such abandonment might expose the acquiring corporation to contractual liability to the target corporation's stockholders who have accepted the offer, or others who have detrimentally relied thereon. [See Corps.C. § 1201(i); see also Corps.C. § 3401(h) (SPCs)]

b. [8:244] **Tax treatment ("B reorganization"):** An exchange of stock is normally taxable the same as a sale; i.e., gain or loss is recognized at the time of the exchange.

But a stock-for-stock exchange will be *tax-free* to the exchanging shareholders (no gain or loss recognized at the time of exchange, and the basis on their former shares carried over to the newly-received shares), if the following requirements are met: (Such an exchange is referred to as a "B reorganization" because it is the second of the seven types of corporate reorganizations recognized in IRC § 368(a)(1).) [IRC § 368(a)(1)(B)]

(1) [8:245] **Continuity of interest:** The same "continuity of interest" required in "A reorganizations" applies here as well; *see ¶ 8:215*.

(2) [8:246] **Solely for voting stock of acquiring corporation:** Subject to the exceptions noted below (¶ 8:246b ff.), there is no room for mixed consideration in a "B reorganization." The exchange must be *solely* for *voting stock* in the acquiring corporation. Any other form of consideration—such as cash, debt securities or even nonvoting stock of the acquiring corporation—renders the *entire* transaction taxable to the exchanging shareholders. [*Turnbow v. Commr.* (1961) 368 US 337, 343-344, 82 S.Ct. 353, 357; see Treas.Reg. § 1.368-2(c); see also *Chapman v. Commr.* (1st Cir. 1980) 618 F2d 856, 860]

(a) [8:246a] **Caution—"voting stock" excludes "nonqualified preferred":** "Nonqualified preferred stock" (*¶ 3:340.1 ff.*) is *not* treated as "voting stock" for purposes of a "B reorganization," and thus receipt of *any* "nonqualified preferred stock" (except in exchange for other "nonqualified preferred stock") will render the transaction *taxable*. [IRC § 354(a)(2)(C)]

(b) [8:246b] **Exception—concomitant exchange of bonds:** A stock-for-stock exchange that, as part of the plan of reorganization, involves an exchange of bonds (or debentures) can still receive tax-free treatment so long as the principal amount of the bonds surrendered equals the principal amount of the bonds received. [Rev.Rul. 98-10, 1998-1 CB 643]

• [8:246c] **Example:** X corporation acquires all the voting stock of Y corporation in exchange for stock in X corporation. X also exchanges all the outstanding bonds of Y for bonds of X having the same principal amount, interest rate and maturity. Some, but not all, Y shareholders are also Y bondholders.

So long as the Y shareholders receive X voting stock *solely in return for their Y voting stock*, and so long as the Y bondholders receive X bonds *solely in return for their Y bonds*, the stock-for-stock exchange is tax-free under IRC § 368(a)(1)(B) and the bond-for-bond exchange is tax-free under IRC § 354(a)(1) (*see* ¶ *8:125, 8:212*). [Rev.Rul. 98-10, supra]

(c) [8:246.1] **Exception—payment for fractional shares; target corporation's expenses:** But the "solely for voting stock" requirement does not prevent the acquiring corporation from paying the target's reorganization expenses, or paying cash in lieu of issuing fractional shares to the target's shareholders. [Rev.Rul. 73-54, 1973-1 CB 187; Rev.Rul. 66-365, 1966-2 CB 116]

(3) [8:247] **At least 80% control acquired:** As a result of the exchange, the acquiring corporation must end up with at least 80% of the target corporation's outstanding voting stock, as well as 80% of the total number of shares of all other classes of stock outstanding. [IRC § 368(c)]

(4) [8:248] **Compare—merger requirements:** If the foregoing requirements cannot be met through a stock-for-stock exchange, tax-free treatment may still be possible through an "A reorganization"; i.e., a statutory merger or consolidation (¶ *8:211*).

c. Securities laws considerations

(1) [8:249] **Federal securities laws:** By definition, a "share exchange tender offer" or an exchange reorganization involves the "offer" and "sale" of securities. Thus, various provisions of the federal securities laws may apply to these types of transactions, including:

(a) [8:250] **Registration requirements** of the 1933 Act (whether the securities "offered" are securities of the acquiring corporation, or of its parent); *see* ¶ *5:19 ff.*

(a) [8:250] Of course, various *exemptions* from registration may also be available … especially the exemption under SA § 3(a)(10), where the exchange is qualified in California upon a "fairness hearing" (¶ *5:194.1 ff.*). Similarly, the preemption provisions of the 1933 Act may preclude state regulation (*see* ¶ *5:18.5 ff.*).

(b) [8:251] **Proxy rules** (SEA § 14 and SEC Reg. 14A) must be complied with if the exchange requires shareholder approval (*see* ¶ *8:238 ff.*), and the acquiring corporation is subject to the reporting requirements of the 1934 Act.

(c) [8:252] **Tender offer rules** (SEA §§ 13(d), 14(d) and 14(e)) require special disclosures and regulate tender offers for any class of equity security registered under the 1934 Act.

(d) [8:253] **Antifraud rules** (SEA § 10(b), and SEC Rule 10b-5) apply, regardless of registration requirements, to exchanges involving the "purchase" and "sale" of securities in interstate commerce; *see* ¶ *6:360*.

(2) [8:254] **California Corporate Securities Law:** Likewise, an exchange is treated as an "offer" and "sale" under the Corporate Securities Law, and therefore must be qualified by permit unless exempt (or preempted by federal law, ¶ *5:18.5 ff.*). [Corps.C. § 25110]

To the extent applicable, the same exemptions are available as in the case of any offer and sale (*see* ¶ *5:200 ff.*). (Thus, share exchanges are treated differently from recapitalizations (¶ *8:156 ff.*), mergers (¶ *8:230 ff.*), and sale-of-assets reorganizations (¶ *8:288 ff.*).) [See Corps.C. § 25120]

(a) [8:254.1] **Limited offering exemption (§ 25102(f)) applicable:** Section 25102(f) is available to exempt share exchange tender offer and exchange reorganization transactions, provided they satisfy all of the requirements under this exemption (*see* ¶ *5:256 ff.*). [Corps.C. § 25102(f)]

(b) [8:255] **Exemption—"forced sale" exchange where less than 25% of target held by California residents:** By Rule, the Financial Protection and Innovation Commissioner has exempted a corporation's issuance of shares in exchange for *all* the outstanding shares (except for directors' qualifying shares) of a target ("acquired") corporation … *provided all* of the following requirements are met:

1) [8:256] Less than 25% of the shares of the class being exchanged (the target shares) are held by California residents —*excluding* shares held in the names of broker-dealers and by persons who control 50% or more of the target shares;

2) [8:257] The exchange is subject to approval by *affirmative vote of at least a majority of the target shares* (or greater vote if required by the target corporation's articles, bylaws, or applicable state law), again excluding shares held by anyone owning, directly or beneficially, 50% or more of such shares; *OR*

The exchange is *approved as to fairness* after a hearing by a regulatory agency having powers similar to the Financial Protection and Innovation Commissioner ("approval after a hearing as to the fairness of its terms and conditions, by public commission, board or other governmental authority of a state expressly authorized by the law of such state to grant such approval"); *AND*

3) [8:258] Any shareholder of the target corporation dissenting from the exchange is entitled to the "fair value" of the shareholder's shares (presumably in cash). [Commr. Rule 260.105.15]

[8:258a] **Comment:** Since "share exchange tender offers" do not trigger "dissenters' rights," such transactions cannot satisfy all of the foregoing requirements. Hence, only "exchange reorganizations" can potentially qualify for this exemption.

[8:258.1] ***Reserved.***

➪ [8:258.2] ***PRACTICE POINTER:*** Even if the exchange is exempt, it may be desirable to obtain qualification upon a "fairness hearing" to exempt the transaction from federal registration under SA § 3(a)(10), *¶ 5:194.1 ff.*

5. [8:259] **Sale-of-Assets Reorganizations:** A "sale-of-assets reorganization" is a sale of corporate assets that has the *effect* of a reorganization, and thus is subject to board and shareholder approval as discussed below (¶ 8:262 ff.). It involves one corporation acquiring all or "substantially all" of the business and assets of another corporation in *exchange*, in whole or part, for the purchaser's (or its parent's) *stock or debt securities*, if such debt securities are not adequately secured and have a maturity date more than five years after the sale. [Corps.C. § 181(c); see also Corps.C. § 2511(c) (SPCs)]

[8:260] Such a purchase and sale is treated as a reorganization because the shareholders of the seller corporation end up owning, directly or indirectly, stock or unsecured long-term debt securities of the acquiring corporation. (If the debt *were* adequately secured and due within five years, the sale would not be treated as a reorganization, but simply as a sale of assets; *see ¶ 8:581*.)

• [8:260.1] ***Compare—reorganization with noncorporate entity:*** A "sale-of-assets reorganization" may be effected between a corporation and a noncorporate entity—i.e., a corporation may issue its or its parent's equity or debt securities in exchange for the business and assets of a noncorporate entity (and a noncorporate entity may issue its or its parent's equity or debt securities in exchange for the business and assets of a corporation). Here again, dissenting shareholders have the right to be "cashed out" (¶ 8:292 ff.). [Corps.C. §§ 168, 181(c); see also Corps.C. § 2511(c) (SPCs)]

However, a sale-of-assets reorganization with a noncorporate entity does *not* qualify as a tax-free "C reorganization" (IRC § 368(a)(1)(C), *¶ 8:276 ff.*). For this reason, the remainder of this discussion focuses on purely corporate sale-of-assets reorganizations.

a. [8:261] **All or "substantially all" assets:** Board and shareholder approval is required as to transfers involving "all or substantially all" the corporate assets. (Lesser amounts can be sold, if in the ordinary course of business, by authorized officers or employees without specific board or shareholder approval. However, as a practical matter, board approval will—and always should—be sought for any substantial asset sale.)

Unfortunately, neither the Corporations Code nor case law sheds much light on precisely what amount or percentage of corporate assets constitutes "substantially all" of the total. Arguably, only transfers that would render the corporation unable to continue in business in its usual way should be so treated.

For *tax purposes*, however, the IRS has provided specific guidelines as to what constitutes "substantially all" of a corporation's assets to qualify as a "C reorganization" (*see ¶ 8:278*).

b. [8:262] **Procedure:** Usually, an agreement for the sale of assets is negotiated by officers of the corporations involved, and then submitted to their respective boards and shareholders for approval.

The agreement normally describes in detail the financial terms, the securities to be issued, the assets to be conveyed, what warranties are made, what liabilities are assumed, etc. If the selling corporation holds a franchise, license or permit for its business, the sale is usually contingent upon obtaining consent to transfer from the appropriate licensing or franchising authority. (See further discussion in "Sale of Assets," *¶ 8:581*.)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [8:263] **Approval by both boards:** A sale of assets reorganization requires approval of the principal terms by the boards of *both* the acquiring corporation (purchaser) and the corporation whose property and assets are being acquired (seller). [Corps.C. § 1200(c); see also Corps.C. § 3400(c) (SPCs)]

(2) [8:264] **Approval by shareholders of both corporations:** The principal terms of the agreement must also be approved by a majority of the outstanding shares of *each class* of *both* corporations or such greater percentage as may be required in their articles. [Corps.C. § 1201(a); see also Corps.C. § 3401 (SPCs)]

(a) [8:264.1] **Caution—two-thirds approval required in certain SPC reorganizations:** The principal terms of the agreement must be approved by at least two-thirds of the outstanding shares of any class of an SPC (or such greater vote as may be required in the articles) if holders of shares of that class receive shares of an *SPC* (or *parent*) having *different* rights than those surrendered, or shares in a *foreign* corporation. [Corps.C. § 3401(d)]

(b) [8:264.2] **Measuring shareholder approval:** *See ¶ 8:173 ff.*

1) [8:264.3] **Foreign corporation shareholder approval:** *See ¶ 8:177.3*.

(c) [8:264.4] **Before or after board approval:** *See ¶ 8:173.1*.

(d) [8:265] **Exception as to unaffected preferred shareholders:** As with other forms of reorganization, approval by nonvoting preferred shareholders of the *acquiring* corporation is not required if their rights remain unchanged by the reorganization (e.g., as where only junior stock is issued). [Corps.C. § 1201(a); see also Corps.C. § 3401(a) (SPCs); *and ¶ 8:240*]

1) [8:265.1] **Preferred shares to receive less than required by articles:** *See ¶ 8:177.2*.

(e) [8:266] **Exception where limited dilution of voting power:** Nor is approval by the acquiring corporation's shareholders required where the sale-of-assets reorganization will result in only a limited dilution of the shareholders' voting power. See the "limited dilution test" *discussed at ¶ 8:181 ff.* [Corps.C. § 1201(b); see also Corps.C. § 3401(b) (SPCs)]

[8:267] **Limitations:** However, as discussed earlier, there are some limitations to this exception: I.e., whether or not their voting power is diluted, shareholder approval is required where:

• [8:268] The reorganization necessitates an *articles amendment* (e.g., to authorize additional shares). [Corps.C. §§ 902(a), 903]

• [8:269] The reorganization contemplates shareholders of either corporation *surrendering* their shares for other shares having *different* rights than those surrendered, or shares in a foreign corporation. (This might apply where the seller corporation plans to liquidate and distribute the shares being acquired from the purchaser corporation.) [See Corps.C. § 1201(d); see also Corps.C. § 3401(d) (SPCs), ¶ 8:264.1; *and ¶ 8:183.2*]

(f) [8:270] **90% approval required if corporations under common control:** If the purchaser corporation has voting control over the seller (or both are under common control), the sale must be approved by *at least 90%* of the voting shares of the seller corporation, rather than a mere majority. (The purpose, of course, is to prevent the purchaser corporation from taking advantage of minority shareholders in the seller corporation.) [Corps.C. § 1001(d); see also Corps.C. § 3100(d) (SPCs)]

1) Exceptions

a) [8:271] **Seller given equity in purchaser:** The 90%-approval requirement does not apply if the purchaser pays for the assets with its own or its parent's *nonredeemable common stock* (or *nonredeemable equity securities* where the issuer is a noncorporate entity). Reason: The minority has a *continuing equity interest* in the business. [Corps.C. § 1001(d)]

1/ [8:271.1] **Added condition re SPCs:** Where the seller is an SPC, this exception to the 90%-approval requirement applies only if the purchaser, in addition to paying for the assets with its own or its parent's non-redeemable equity securities, is an SPC (or other business entity) whose articles (or other organizational document) specify *materially the same purposes*. [Corps.C. § 3100(d)]

b) [8:271.2] **Sale approved by Commissioner:** Nor does the 90%-approval requirement apply if the Financial Protection and Innovation Commissioner, after a hearing, has approved the "fairness" of the transaction. [Corps.C. § 1001(e); see also Corps.C. § 3100(e) (SPCs)]

2) [8:272] **Compare—alternatives available:** If a parent corporation has 90% or more voting control of a subsidiary, it can "cash out" the minority shareholders at any time: *either* through a "short-form" merger (¶ *8:196*), or through a sale-of-assets reorganization and then liquidating the subsidiary.

With *less* than 90% control, however, no "short-form" merger is possible (*see* ¶ *8:196*). Therefore, a parent corporation must either obtain approval by enough of the minority shareholders to satisfy the 90% approval requirement for a sale-of-assets reorganization, *or* pay for the assets purchased in non-redeemable common shares, *or* seek approval as to the "fairness" of the transaction by the Financial Protection and Innovation Commissioner.

(g) [8:273] **Dissenters' rights:** For further discussion of the rights of dissenting shareholders, *see* ¶ *8:292 ff.*

(3) [8:273.1] **Sale-of-assets reorganization proposed by insider:** Where the sale-of-assets reorganization is proposed by an *insider*—i.e., an "interested party"—special requirements are imposed to assure that the shareholders will be treated fairly in the non-arm's-length transaction.

(a) [8:273.2] **Who is an "interested party":** The special requirements apply to sale-of-assets reorganization proposals made to a corporation by anyone who:

• Directly or indirectly *controls* the corporation;

• Is directly or indirectly controlled by any of the corporation's officers or directors; or

• Is an entity in which any of the corporation's directors or "executive officers" (i.e., president, vice-president, or other persons serving similar policymaking functions) holds a *material financial interest*. [Corps.C. § 1203(a)]

1) [8:273.3] **Exception—corporations with fewer than 100 shareholders:** The special requirements do not apply where the proposal is made to a corporation with *fewer than 100* shareholders of record. [Corps.C. § 1203(a) (last para.)]

2) [8:273.4] **Exception—exchange qualified by permit:** Nor do the special requirements apply to a transaction that has been qualified by permit from the Financial Protection and Innovation Commissioner. [Corps.C. § 1203(a) (last para.)]

(b) [8:273.5] **Independent fairness opinion:** The interested party proposing the sale-of-assets transaction must provide the shareholders with an independent written opinion as to the fairness of the consideration they will receive in the transaction. [Corps.C. § 1203(a)]

1) **Opining person's qualifications:** *See* ¶ *8:172.10*.

2) **Delivery of opinion:** *See* ¶ *8:172.11*.

(c) [8:273.6] **Competing offers:** The board of directors must notify the shareholders of any competing offer requiring shareholder acceptance or approval made at least 10 days before the interested party proposal is to be approved, whether a tender offer, a merger offer, a stock-for-stock exchange (¶ *8:235 ff.*), a sale-of-assets reorganization (¶ *8:259 ff.*) or a straight sale-of-assets requiring shareholder approval (¶ *8:581 ff.*). The directors must also forward to the shareholders any written materials provided by the later offeror (at such offeror's expense). [Corps.C. § 1203(b)(1)]

1) **Insider proposal delayed pending shareholder action on competing offer:** *See* ¶ *8:172.13*.

2) **Improving insider offer:** *See* ¶ *8:172.14*.

➪ [8:273.7] ***PRACTICE POINTER:*** When an insider proposal is submitted to the shareholders for approval, the corporation should disclose that competing offers received at least 10 days before the proposal is approved also will be submitted for shareholder consideration.

(4) [8:274] **Abandonment:** The boards of either corporation have power to call off a sale-of-assets reorganization any time before the sale is consummated. But such abandonment may expose the withdrawing party to contractual liability to the other corporation, and to any third parties who have enforceable rights under such contract. [Corps.C. § 1201(i); see also Corps.C. § 3401(h) (SPCs)]

(5) [8:275] **Documentation:** Bills of sale, deeds to real property, assignments and other documentation will be required to transfer the selling corporation's business and assets. (See further discussion in "Sale of Assets" at ¶ *8:631*.)

(6) [8:275.1] **Seller corporation's liabilities imposed on acquiring corporation ("de facto mergers"):** Generally, a purchaser of assets does not assume the seller's liabilities. However, a sale that leaves the selling corporation unable to satisfy its creditors and that has the *same practical result as a merger* and may be treated as a "*de facto merger*"—i.e., the purchaser will be liable for *all* the seller's debts by operation of law, the same as in a merger (*¶ 8:193*). (This includes liability for punitive damages claims; *see ¶ 8:194*.)

A transaction cast as an asset sale has the same effect as a merger and will be treated as a "de facto merger" where:

• The consideration paid for the assets consisted *solely* of the purchaser's (or its parent's) *stock*;

• The purchaser continued the same business after the sale;

• The seller's shareholders became shareholders of the purchaser;

• The seller corporation liquidated; and

• The purchaser assumed those liabilities necessary to carry on the business. [*Franklin v. USX Corp.* (2001) 87 CA4th 615, 625-627, 105 CR2d 11, 17-19—no de facto merger where adequate cash consideration paid for seller corporation's assets ("The crucial factor in determining whether a corporate acquisition constitutes either a de facto merger or a mere continuation is the same: whether adequate cash consideration was paid for the predecessor corporation's assets"); *Marks v. Minnesota Mining & Mfg. Co.* (1986) 187 CA3d 1429, 1436, 232 CR 594, 598; see *United States v. Oil Resources, Inc.* (9th Cir. 1987) 817 F2d 1429, 1434 & fn. 6; *and ¶ 8:656 ff.*; compare *Schwartz v. Pillsbury, Inc.* (9th Cir. 1992) 969 F2d 840, 846—no "de facto merger" in sale of assets for cash]

(a) [8:275.2] **Compare—product liability claims:** Successor liability for product liability claims may be imposed even where an asset sale is made entirely for cash, if the transaction leads to the seller's liquidation or dissolution (*see ¶ 8:663 ff.*).

(7) [8:275.3] **Special employee notice requirements (layoffs, plant closures, relocations):** If the asset sale results in a *mass layoff* or a *plant closure or relocation* affecting at least 50 employees, special notice requirements may need to be satisfied pursuant to the federal Worker Adjustment and Retraining Notification Act ("WARN Act," 29 USC §§ 2101-2109) and its California counterpart (Lab.C. § 1400 et seq.). *See discussion at ¶ 8:1041 ff.*

c. [8:276] **Tax treatment ("C reorganization"):** Ordinarily, a sale of assets is a taxable event; i.e., gain or loss is recognized when the sale occurs (*see ¶ 8:701*).

But a sale may be a *tax-free* exchange if it qualifies as a "C reorganization" (so-called because it is the third type of reorganization described in IRC § 368(a)(1)). If so qualified, no gain or loss is recognized by the selling corporation (or its shareholders) at the time of sale. Rather, the selling corporation takes a *carryover basis* in the securities received from the purchaser in exchange for the assets sold. Tax is payable only when those securities are ultimately sold. [IRC § 358(a)(1)]

To qualify as a tax-free "C" reorganization, the transaction must satisfy the same "continuity of interest" as required in "A" and "B" reorganizations (¶ *8:215, 8:245*). The following specific requirements must also be met:

(1) [8:277] **Substantially all assets sold:** First of all, the purchaser corporation must acquire "*substantially all* of the properties" of the seller corporation. [IRC § 368(a)(1)(C)]

(a) [8:278] **IRS guidelines:** For advance ruling purposes, the IRS interprets "substantially all" to require transfer of *both:*

• *At least 90%* of the fair market value of the selling corporation's *net* assets; *and*

• *At least 70%* of the fair market value of its *gross* (total) assets. [Rev.Proc. 77-37, 1977-2 CB 568]

(b) [8:278.1] **Applies where portion of assets sold for cash:** A transfer of *all* the seller corporation's assets in exchange for voting stock satisfies the "substantially all" requirement, even though the seller sold half or more of its historic business assets to others for cash just before the transfer and transferred the cash to the purchaser corporation. [See Rev.Rul. 88-48, 1988-1 CB 117]

(2) [8:279] **Exchange for purchaser's voting stock:** The assets must be acquired "*solely* in exchange for" *voting stock* (excluding "nonqualified preferred," *¶ 3:340.1 ff.*) in the purchaser corporation or its parent corporation. [IRC § 368(a)(1)(C); see IRC § 354(a)(2)(C)]

Thus, use of debt securities, nonqualified preferred stock or cash to pay for the assets, in whole or in part, renders the *entire* transaction taxable at the time of sale (except as noted below, ¶ 8:282).

[8:280] **Compare:** For *corporate law* purposes, a sale of assets in exchange for the purchaser's long-term debt securities may be treated as a "reorganization" and thus require board and shareholder approvals (see Corps.C. § 181(c), ¶ 8:259; see also Corps.C. § 2511(c) (SPCs)). But for *tax purposes*, a sale of assets for even long-term debt securities *does not qualify* as a tax-free "reorganization."

(a) [8:281] **Assumption of liabilities disregarded:** However, the purchaser corporation in a sale-of-assets reorganization *may* assume the seller corporation's debts or liabilities. The fact that the assets purchased are subject to certain liabilities, or that the purchaser has assumed the seller's liabilities, is disregarded in determining whether the transfer is "solely" in exchange for voting stock. [IRC § 368(a)(1)(C)]

(b) [8:281.1] **Asset sale to existing shareholder permitted:** The purchaser corporation's ownership of stock in the seller corporation prior to the asset acquisition (i.e., the seller is a partially-owned subsidiary of the purchaser) does not prevent the transaction from qualifying as a "C reorganization." [Treas.Reg. § 1.368-2(d)(4)]

(c) [8:282] **"Boot" permitted if at least 80% of assets acquired for stock:** One narrow exception allows part payment in "boot" (i.e., cash, debt securities or property other than voting stock) of up to 20% of the fair market value of the transferor corporation's assets. In other words, the acquisition is tax-free if at least 80% of the assets' value is purchased with voting stock. And, for this purpose only, liabilities assumed by the purchaser are treated the same as cash paid for such assets. [IRC § 368(a)(2)(B)]

For example, assume Transferor Corp.'s total assets are worth $100,000, subject to $10,000 liabilities. If Purchaser Corp. pays $10,000 in cash (or other property), assumes the $10,000 liabilities, and issues voting stock for the balance of assets, it will still be treated as a tax-free "C reorganization."

(3) [8:282.1] **Transferor corporation must distribute stock:** The final requirement for a "C reorganization" is that *all* of the transferor corporation's remaining assets (less amounts retained to pay claims)—including the stock and any "boot" (¶ 8:282) received from the purchaser—must be distributed to the transferor corporation's shareholders (or its creditors) pursuant to the plan of liquidation. IRS Regulations may waive this requirement (but none has yet been adopted). [IRC § 368(a)(2)(G)]

(4) [8:282.2] **No gain or loss recognized by corporation:** Generally, the transferor corporation does not recognize either gain or loss *on receipt* of the purchaser corporation's stock or any "boot" (i.e., cash, debt securities or property other than voting stock). [IRC § 361] Nor will it recognize gain or loss on subsequent distribution of such *stock* under the reorganization plan. [IRC § 336(c)]

(a) [8:282.3] **Exception for "boot" and other assets:** But the transferor corporation will recognize *gain* (but not loss) on appreciation in its *remaining assets* (including any "boot" received in the transaction) when it distributes the assets to its shareholders (or creditors). [IRC § 361(c)]

The impact of recognizing gain on the "boot" distributed is mitigated by the fact that the transferor corporation is given a fair market value basis upon receiving it. Thus, any gain would only be from appreciation in value *after* the "boot" was received by the transferor corporation. [IRC § 361(b)(2)]

d. [8:283] **Securities laws considerations:** The purchaser corporation's issuance of securities in exchange for assets is treated as a "sale" of such securities, and hence subject to applicable provisions of federal and California securities laws.

(1) [8:284] **Federal securities laws:** The following provisions of federal law should be considered in connection with any sale-of-assets reorganization:

(a) [8:285] **Proxy rules** of the 1934 Act (SEA § 14(a), Reg. 14A), where shareholder approvals or consents are required (*see ¶ 8:264 ff.*) and the corporation is subject to the registration and reporting requirements of the Act.

(b) [8:286] **Registration requirements** and *exemptions* under the 1933 Act. Since the new securities are being issued to only one "purchaser" (the selling corporation), the offer and sale will usually be exempt under the "private offering exemption" (SA § 4(a)(2)), or under Regulation D; *see ¶ 5:171*.

Remember, however, that securities issued under these exemptions are *restricted* as to resale or retransfer (under SEC Rule 144, *¶ 5:126 ff.*). Therefore, these exemptions should not be used where the reorganization plan contemplates that the selling corporation will distribute to its own shareholders the securities received from the purchaser corporation

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(either as a dividend or in dissolution, or otherwise within one year after its shareholders approved the asset sale). In such cases, the issuance should be registered under the 1933 Act. [See SEC Rule 145]

(c) [8:287] **Antifraud rules** (SEA § 10(b) and SEC Rule 10b-5) apply to stock-for-assets exchanges since they involve the "purchase" and "sale" of securities. (Dissenting shareholders of the acquired corporation are treated as "forced" sellers.) The securities need not be registered for the antifraud rules to apply, but the sale or issuance must satisfy the interstate commerce limitation (*see* *¶ 6:362*).

(2) [8:288] **California Corporate Securities Law:** Negotiations and agreements between the boards of directors of the two corporations involved in stock-for-assets exchange (prior to soliciting shareholder approval) are exempt from qualification. [Corps.C. § 25103(a)]

However, once shareholder approval is sought, the "offer" or "sale" of the purchaser corporation's securities is subject to qualification by permit, unless exempt. [Corps.C. §§ 25120, 25121]

(a) [8:289] **Exemptions:** Most of the reorganization exemptions discussed earlier in connection with recapitalizations, mergers, and stock-for-stock exchanges *do not apply* in stock-for-assets exchanges. [Corps.C. § 25103; Commr. Rule 260.103, 260.105.15]

1) [8:289.1] **"Nonresident shareholders exemption":** However, the "*nonresident shareholders exemption*" (*¶ 8:231*) may be applicable: i.e., if the stock being issued by the purchaser corporation is to be redistributed by the seller corporation to its shareholders, less than 25% of whom reside in California, the exchange is exempt from qualification. [Corps.C. § 25103(c)]

2) [8:289.2] **"Limited exchange transaction exemption":** Further, the "limited exchange transaction exemption," available for certain mergers, also applies to sales of assets; *see* *¶ 8:232.1 ff.* [Corps.C. § 25103(h)]

[8:289.3] ***Reserved.***

a) [8:289.4] **Compare—less than all (or substantially all) assets exchanged for stock:** If only *some*—i.e., less than all or substantially all—of the seller's assets are being exchanged for stock, the transaction will *not* qualify as a "sale-of-assets reorganization"; instead, it will constitute an ordinary stock issuance for property, as to which the Corps.C. § 25102(f) "limited offering exemption" (rather than the Corps.C. § 25103(h) "exchange transaction exemption") may apply (*see* *¶ 5:256 ff.*).

3) [8:289.5] **Exchanges approved by bankruptcy court:** The exemption for exchanges of securities approved by a bankruptcy court in a *merger* transaction also applies to *asset sales; see* *¶ 8:232.10*. [Corps.C. § 25103(i)]

[8:290] ***Reserved.***

(b) [8:291] **Qualification procedure:** If no exemption is available, the purchaser corporation's issuance of securities must be qualified by permit from the Financial Protection and Innovation Commissioner. The procedure for obtaining such permit is the same as discussed in connection with recapitalizations and mergers; *see* *¶ 8:157*.

6. [8:292] **Dissenters' Rights:** Dissenting shareholders have the right to be paid the appraised value of their shares following certain reorganizations and similar transactions (*see* *¶ 8:293.2 ff.*) that cause a fundamental change in the corporation. [Corps.C. § 1300 et seq.]

a. [8:293] **Purpose:** Assuring dissenting shareholders the right to be "cashed out" for the fair value of their investments serves two purposes: It protects minority shareholders against being locked by majority fiat into an investment which, as a result of the reorganization, may be substantially different than they originally bargained for.

At the same time, it generally precludes minority shareholders attempting to thwart reorganizations by filing "strike suits" or otherwise challenging the majority's decision. As will be seen, if the reorganization is otherwise duly authorized, the minority shareholders' statutory appraisal rights are virtually their *sole and exclusive remedy*. [Corps.C. § 1312, *see* *¶ 8:358*]

b. [8:293.1] **Not applicable in reorganization, merger or conversion where articles contain payment amount:** Statutory dissenters' rights do *not* apply to a class of shares if the articles set forth the amount to be paid with respect to such shares in a *reorganization, merger or conversion*. But statutory dissenters' rights may apply to a class of shares even if the articles set forth the amount to be paid with respect to such shares in a *change of status* from one corporate form to another (*see* *¶ 8:293.5*). (As a practical matter, the articles rarely spell out the amount that dissenting shareholders of a particular class are

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

entitled to be paid.) [Corps.C. § 1311; see Corps.C. § 1313—conversion deemed reorganization for purposes of dissenters' rights (¶ 8:293.4)]

c. Transactions triggering dissenters' rights

(1) [8:293.2] **Reorganizations:** Dissenters' rights apply in any acquisitive reorganization—i.e., a merger, stock-for-stock exchange or stock-for-assets exchange. (There is *no* provision for dissenters' rights in connection with share exchanges that are *not* "reorganizations"; *see ¶ 8:235.1*.) [Corps.C. § 1300(a); see Corps.C. § 1201(a), (b), (e), (f); see also Corps.C. § 1112.5(b)—dissenters' rights apply where corporation merges into SPC, ¶ 9:58]

(a) [8:293.3] **Compare—SPCs:** The Social Purpose Corporations Act provides for dissenters' rights in a *merger* only where the disappearing corporation is an SPC and the surviving entity is *not an SPC* or is an SPC whose articles of incorporation set out *materially different purposes*. [Corps.C. § 3201; ¶ 9:313.1]

There is no provision in the Social Purpose Corporation Law for dissenters' rights in connection with *stock-for-stock exchanges* or *stock-for-assets exchanges*. [See Corps.C. §§ 3400, 3401; see also Corps.C. § 2511 ("reorganization" defined)]

(2) [8:293.4] **Conversions to noncorporate entity:** Dissenters' rights also apply when a corporation converts into a noncorporate business entity. A conversion is deemed a "reorganization" for this purpose (*see ¶ 8:473*). [Corps.C. § 1313; see also Corps.C. §§ 3302(b), 3305 (SPCs)]

(3) [8:293.5] **Change of status:** Dissenters' rights also apply when the articles of incorporation are amended to change the status of:

- A nonbenefit corporation into a benefit corporation. [Corps.C. § 14603(a); ¶ 9:534]

- A benefit corporation into a nonbenefit corporation (also referred to as termination of status as a benefit corporation). [Corps.C. § 14604(a); ¶ 9:664]

- An SPC into a nonSPC ("business") corporation. [Corps.C. § 3002(c); *see ¶ 9:281*]

But an articles amendment to change the status of a *nonSPC corporation into an SPC* does *not* trigger dissenters' rights. [See Corps.C. § 911]

(a) [8:293.6] **Comment:** It is anomalous that dissenters' rights apply expressly to a *merger* of a nonSPC corporation into an SPC (*see ¶ 8:293.2*), but not to an articles amendment changing a nonSPC corporation's status to an SPC. This is likely a legislative oversight.

(4) [8:293.7] ***Not recapitalizations:*** Dissenters' rights are *not* available in connection with *recapitalizations*, since they involve "purely internal" reshuffling of the corporation's capital structure. *See ¶ 8:123*.

d. [8:294] **Shares eligible for appraisal rights:** To be eligible for statutory appraisal rights, the shares must qualify as "dissenting shares." [Corps.C. § 1300(b)]

To qualify as "dissenting shares," such shares must meet the following requirements:

(1) [8:295] **Shares outstanding:** To be eligible for appraisal rights, shares must actually be outstanding and held of record on the record date for determining shareholders entitled to vote on the reorganization (or, in the case of "short-form" mergers, on the effective date of the merger). [Corps.C. § 1300(b)(2)]

(a) [8:296] **Compare—unexercised stock rights:** Thus, stock options, warrants, conversion rights, etc., not yet exercised as of the record date for determining shareholders entitled to vote on the reorganization, are *not* eligible for appraisal rights. It makes no difference that they *could* have been exercised, if in fact they had not been. (The holder may still have the right to exercise such options, warrants, etc., but not the right to have those shares cashed out.)

(2) [8:297] **Shares NOT readily marketable:** To be eligible for appraisal rights, the shares must not be readily salable. The purpose of appraisal rights is to enable a dissenting shareholder to cash out the shareholder's investment for its fair value. Thus, there is no need for such rights where the shares are readily marketable for their fair value. [See Corps.C. § 1300(b)(1)]

(a) [8:298] **Shares deemed readily marketable:** Shares meeting the following descriptions and conditions are deemed readily marketable, and thus *ineligible* for dissenters' appraisal rights:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• [8:299] **Old shares not listed on national securities exchange:** Immediately prior to the reorganization, the shares were *not* listed on a national securities exchange certified by the Financial Protection and Innovation Commissioner under Corps.C. § 25100(o) (*see ¶ 5:198.1*) (if they are so listed, the shareholder must vote *against* the reorganization; *see ¶ 8:313*); *and*

• [8:300] **New shares listed on national securities exchange and fractional shares cashed out:** The shareholders will receive only shares listed on a national securities exchange certified by the Commissioner under Corps.C. § 25100(o) (*see ¶ 5:198.1*) and/or cash *in lieu of fractional shares* (cash in return for *all* shares does not qualify—i.e., dissenters' appraisal rights apply); *and*

• [8:301] **Not restricted as to transferability:** The shares are *not restricted* as to resale, either by the corporation (e.g., buy-sell agreements, etc.) or by any law or regulation (e.g., not "restricted" shares subject to SEC Rule 144); *and*

• [8:302] **Holders notified of appraisal rights:** The *notice* of the shareholders' meeting to act on the proposed reorganization (*see ¶ 8:325 ff.*) accurately summarized the provisions of Corps.C. §§ 1300-1304, so as to advise all shareholders of the scope of their appraisal rights and the procedures to be followed to exercise them. [Corps.C. § 1300(b)(1)]

1) [8:302.1] **Elimination of 5% requirement:** For many years, Corps.C. § 1300(b)(1) denied dissenters' rights to holders of "listed" shares unless holders of 5% or more of those shares elected to pursue dissenters' rights. This provision was eliminated effective January 1, 2013. [See Stats. 2012, Ch. 473]

(3) [8:303] **Shares entitled to vote on reorganization:** Statutory appraisal rights are available only as to shares whose approval of the reorganization is required pursuant to Corps.C. § 1201(a), (b), (e) or "(f)". [Corps.C. § 1300(a)]

Caution re § 1201(f)—statutory typo: The 2011 legislation that created flexible purpose corporations (now known as social purpose corporations, *see ¶ 9:3*) also amended Corps.C. § 1201 to add a new subdivision (f). However, Corps.C. § 1300(a) was not amended to change the existing reference from Corps.C. § 1201(f) to (g). This was clearly an oversight. Until "clean-up" legislation is enacted, references in Corps.C. § 1300(a) to § 1201(f) should be read as Corps.C. § 1201(g).

(a) [8:304] **Shares ineligible because not entitled to vote:** Thus (except as noted below; ¶ 8:307 ff.), if the transaction does *not* require shareholder approval pursuant to the foregoing sections, objecting shareholders have no right to be cashed out. This applies to:

1) [8:305] **Preferred shares unaffected by reorganization:** Approval by preferred shareholders of the surviving or acquiring corporation is not required if their rights remain unchanged by the proposed reorganization (Corps.C. § 1201(a); *see ¶ 8:179*). Thus, such shareholders cannot exercise statutory appraisal rights. [Corps.C. § 1300(a)]

2) [8:306] **Shares whose voting power not significantly diluted:** Nor is approval required by shareholders of the surviving or acquiring corporation if the proposed reorganization will result in only a limited dilution of their voting power. (See the "limited dilution test" *discussed at ¶ 8:181*.) It follows that such shareholders have no right to be cashed out as a result of the reorganization. [Corps.C. § 1300(a)]

a) [8:307] **Exception—statutory close corporation:** Dilution of voting power is irrelevant where the reorganization involves shareholders of a *statutory close corporation* receiving shares in a corporation that is not a statutory close corporation. Ordinarily, such shareholders must approve the reorganization by at least a two-thirds vote (*see ¶ 8:176*). And those who dissent are *entitled to be cashed out* even if there is only limited dilution of their voting power. [Corps.C. § 1300(a)]

b) [8:307.1] **Exception—merger with surviving SPC and disappearing nonSPC:** Dilution of voting power is likewise irrelevant in a merger where the survivor is an SPC and the disappearing corporation is not an SPC. Here again, the disappearing corporation's shareholders ordinarily must approve the merger by at least a two-thirds vote (*see ¶ 8:176.1*), and dissenters are *entitled to be cashed out* even if there is only limited dilution of their voting power. [Corps.C. §§ 1112.5(b), 1300(a)]

(b) [8:308] **Compare—short-form mergers:** In short-form mergers, minority shareholder approval is not required for the merger (*see ¶ 8:205.5*), but they are entitled to be cashed out in any case. [Corps.C. § 1300(a)]

(c) [8:309] **Compare—shareholder approval required under other provisions:** Appraisal rights are provided only where shareholder approval of the reorganization is required under Corps.C. § 1201(a), (b), (e) or "(f)" (*see ¶ 8:303*). [Corps.C. § 1300(a)]

Shareholder approval of the transaction may still be required under other subsections. But, those other subsections do not entitle dissenting shareholders to compel the corporation to cash them out.

1) [8:310] **Example:** Approval by shareholders of the acquiring corporation is not required under Corps.C. § 1201(b) if the reorganization will not result in significant dilution of their voting power (*see ¶ 8:306*).

But their approval may still be required under Corps.C. § 1201(c) if a merger requires an articles amendment (*see ¶ 8:241.1*); or, under Corps.C. § 1201(d) if it requires them to surrender their shares for others having different rights, preferences, privileges or restrictions (*see ¶ 8:183.2*).

Even so, there are *no* dissenters' appraisal rights in such cases.

2) [8:311] **Rationale:** Shareholders have no right to be cashed out simply because they oppose an articles amendment, or a change in the attributes of their shares. There is no reason, therefore, that they should have such right merely because the amendment or change is required in connection with a reorganization.

(4) [8:312] **Shares not voted in favor of reorganization:** Active opposition to the reorganization need not be shown to qualify for dissenters' appraisal rights. In general, it is sufficient that the shares were *not* voted in *favor* of the reorganization; i.e., passive opposition is enough. [Corps.C. § 1300(b)(2)]

(a) [8:313] **Compare—listed shares must be voted against:** The holders of listed shares (*see ¶ 8:299*) must *actually vote* such shares *against* the reorganization at any shareholders' meeting called to approve the reorganization. (This requirement does not apply where shareholder approval is by written consent rather than at a meeting.) [Corps.C. § 1300(b)(2)]

(b) [8:314] **Comment:** The purpose of requiring shareholders in listed corporations to vote against the merger presumably is to allow public corporations to know the extent of dissenting shares by the time of the shareholders' meeting and to plan accordingly. (The acquiring corporation may have the contractual right under the reorganization agreement to *terminate* the reorganization if the holders of a certain amount of shares of the target corporation exercise their dissenters' rights.)

(5) [8:315] **Shares qualified procedurally:** The final requirement for "dissenting shares" status is that the shareholder comply with the procedural requirements for exercising appraisal rights, discussed in the following section. [Corps.C. § 1300(b)(3), (4)]

e. [8:316] **Procedure for exercising appraisal rights:** If shares are eligible for statutory appraisal rights (¶ 8:303 ff.), four steps must be taken by the holder to perfect the holder's statutory right to be "cashed out" in the reorganization:

• [8:317] First, as discussed above (¶ 8:312), the shareholder must *refrain* from voting in *favor* of the reorganization; and, in the case of "listed" stock, must affirmatively vote *against* it if the approval is sought at a shareholders' meeting. [Corps.C. § 1300(b)(2), *¶ 8:313*]

• [8:318] Second, the shareholder must make *timely demand* upon the corporation for cash payment. [Corps.C. § 1301]

• [8:319] Third, the shareholder must timely *deliver* the share *certificate* to the corporation for "endorsement as dissenting shares." [Corps.C. § 1302, *¶ 8:329 ff.*]

• [8:320] Fourth, if no agreement is reached with the corporation as to the price to be paid, the shareholder must timely *sue* to have the court fix the fair value of the shares. [Corps.C. § 1304, *¶ 8:334 ff.*]

(1) [8:321] **Shareholder demand upon corporation:** Shareholders seeking to exercise their right to compel the corporation to purchase their shares on reorganization must make timely written demand on the corporation. [Corps.C. § 1301(b)]

(a) [8:322] **Time limit for shareholder demand:** The shareholder's written demand must be *received* by the corporation (or its transfer agent) as follows:

• In the case of "listed" stock (*see ¶ 8:299*), not later than the date of the *shareholders' meeting* to vote on the proposed reorganization;

• In all other cases (including "listed" shares where shareholder approval is sought by written consent instead of at a meeting), the demand must be received within *30 days after notice* of approval by outstanding shares (*see ¶ 8:325 ff.*) has been mailed by the corporation to the shareholders. (In the case of short-form mergers, the demand must be received within 30 days after the corporation mailed notice that the merger was to become effective.) [Corps.C. § 1301(b)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• [8:323] **Comment:** The Corps.C. § 1301(b) requirement that demand be received not later than the date of the shareholders' meeting applies "in the case of shares described in subdivision (b) of Section 1300." Corps.C. § 1300(b) describes both listed shares and shares that are not listed (indeed, "dissenting shares" are defined generally not to include listed shares). Accordingly, § 1301(b) could be read to require that the holders of shares of *any* corporation —whether the shares are listed or not—must exercise their dissenters' rights on or before the date scheduled for the meeting. This is the approach taken by Model Business Corporation Act § 13.21(a)(1) and makes more sense: If shareholders are prepared to vote on the reorganization by the time of the meeting, they should also be prepared to exercise their dissenters' rights.

[8:324] ***Reserved.***

1) [8:325] **When prior notice required from corporation:** Except for listed stock (¶ *8:322*), the time for demand by dissenting shareholders does not begin to run until the corporation has first mailed notice to the shareholders, alerting them to their statutory appraisal rights.

2) [8:325.1] **Contents of corporation's notice:** The corporation's notice must be mailed to all shareholders of record *within 10 days following shareholder approval* of the reorganization; and must contain the following:

• Notice that the reorganization has been approved by affirmative vote of a majority of the outstanding voting shares;

• A copy of Corps.C. §§ 1300-1304 (setting forth dissenting shareholders' rights and the procedure to enforce those rights);

• A statement of the price determined by the corporation to represent the fair market value of the dissenting shares; and

• A "brief description" of the procedure to be followed if the shareholder exercises the shareholder's rights as a dissenting shareholder. [Corps.C. § 1301(a)]

3) [8:326] **Notice as irrevocable offer:** The corporation's notice constitutes an *irrevocable* offer by the corporation to purchase any dissenting shares at that price (unless the shares lose their status as such, *see* ¶ *8:352*). [Corps.C. § 1301(a)]

(b) [8:327] **Contents of shareholder demand:** The dissenting shareholder's demand to the corporation must state:

• The number and class of shares held of record by the shareholder which the shareholder demands the corporation purchase; and

• The amount the shareholder claims to be the fair market value of those shares as of the day of, and immediately prior to, the first announcement of the proposed reorganization (or short-form merger). [Corps.C. § 1301(c); see Corps.C. § 1300(a)]

FORM: Demand for Purchase of Shares (Corps.C. § 1301), *see Form 8:G*.

1) [8:328] **Demand as irrevocable offer:** The dissenting shareholder's demand constitutes an *irrevocable* offer by such shareholder to sell the shareholder's shares at such price. [Corps.C. § 1301(b), (c)]

Thus, the shareholder may not withdraw such demand (offer) unless the corporation consents. [Corps.C. § 1308]

(2) [8:329] **Delivering certificate for endorsement:** Next, in order to perfect their appraisal rights, the dissenting shareholders must submit their share certificates to the corporation or its transfer agent for endorsement as "dissenting shares." (Exception: If the corporation has adopted uncertificated shares (¶ *5:472*), the shareholder need only deliver a written notice stating the number of shares the shareholder demands that the corporation purchase.) [Corps.C. § 1302]

(a) [8:330] **Time limit for delivery:** The certificates (or written notice) must be submitted no later than 30 days after the date on which the corporation mailed notice of shareholder approval of the reorganization (¶ 8:325.1). [Corps.C. § 1302]

(b) [8:331] **Endorsement by corporation:** The purpose of requiring the shareholders to submit their certificates is to enable the corporation to stamp or endorse thereon a statement that the shares are dissenting shares (or to exchange them for new certificates so stamped or endorsed). [Corps.C. § 1302]

On any subsequent transfer of the shares in question, the new certificates (or "initial transaction statement" if the corporation has adopted uncertificated shares, *¶ 5:472*) must bear a like statement (i.e., that the shares are dissenting shares), together with the name of the original dissenting holder of the shares. [Corps.C. § 1302]

(This prevents a holder in due course from acquiring the certificate, unaware that the shares are being sold to the corporation.)

(3) [8:332] **Obtaining payment where value agreed upon:** If the corporation and shareholder agree that the shares qualify as "dissenting shares" (¶ 8:294 ff.), and also agree upon the price of the shares, the only remaining step is to obtain payment from the corporation. Such payment is due within 30 days after the date of such agreement, or after all statutory or contractual conditions to the reorganization have been satisfied, whichever is later. [Corps.C. § 1303(b)]

(a) [8:333] **Plus interest:** The shareholder is also entitled to interest from the agreement date to the date of actual payment. The interest rate is 10% (the legal rate generally applicable to judgments). [Corps.C. § 1303(a); CCP § 685.010(a)(1)]

(4) [8:334] **Action to enforce payment where no agreement:** If the corporation denies that the shares qualify as "dissenting shares," or the corporation and shareholder are unable to agree on the price for the shares, legal action is required. Either the shareholder or the corporation may commence the action in the "appropriate" superior court. [Corps.C. § 1304(a)]

(a) [8:335] **Time limit for commencing action:** Any such action must be commenced within *6 months* after the corporation mailed notice of shareholder approval of the reorganization (*¶ 8:325*). [Corps.C. § 1304(a)]

(b) [8:336] **Joinder and consolidation of actions:** Any two or more dissenting shareholders may join as plaintiffs in such action (or be joined as defendants, if the action is instituted by the corporation). And, if separate actions have been filed by such shareholders, they may be consolidated. [Corps.C. § 1304(b)]

(c) [8:337] **Issues to be tried:** If the corporation denies that plaintiffs' shares qualify as "dissenting shares," that issue must be tried first. If that is resolved in plaintiffs' favor, the court may then determine the fair market value of such shares. [Corps.C. § 1304(c)]

1) [8:338] **Valuation date:** The fair market value of dissenting shares is to be determined as the *day of, and immediately prior to, the first announcement* of the terms of the proposed reorganization or short-form merger—thus excluding any change in value resulting from the proposed action. [Corps.C. § 1300(a)]

[8:339] Appreciation or depreciation in value thereafter is disregarded (except if a stock split, reverse stock split or stock dividend becomes effective after the date of the announcement, the shares' value must be adjusted accordingly). [Corps.C. § 1300(a)]

(d) [8:340] **Procedure for determining value (appraisal process):** Whenever the fair market value of the shares is in dispute, the court may either determine such value itself, or appoint one or more impartial appraisers to make such determination. [Corps.C. § 1304(c)]

The court is *not* required to appoint appraisers. Nor, if it does so, is it required to accept their determination of market value—i.e., the court may make its own determination of value, based on whatever evidence is before the court.

1) [8:341] **Report by appraisers:** If the court appoints appraisers, they must proceed "forthwith" to determine the shares' market value; and to file a written report of such determination with the court clerk within whatever time is set by the court. [Corps.C. § 1305(a)]

2) [8:342] **Court may accept or reject:** As stated, the report is not conclusive. Rather, on motion of any party, it may be submitted to the court, and considered as *evidence* of value. If the court finds the report reasonable, it may accept such determination as being the value of the shares in question. [Corps.C. § 1305(a)]

a) [8:342.1] **"Net book value" method may be proper:** The court may accept an appraisal based on the "net book value" method (i.e., the net book value of the corporate assets minus liabilities, divided by the number of outstanding shares) if the corporation has no real earnings or other value based on earnings capacity. [*Meadows v. Bicrodyne Corp.* (9th Cir. 1986) 785 F2d 670, 673]

3) [8:343] **Determination by court:** If the appraisers fail to agree or fail to file a report within 10 days of their appointment (or such time as allowed by the court), or if their determination of value is not accepted by the court, the court will make its own determination of the value of the dissenting shares. [Corps.C. § 1305(b)]

4) [8:344] **Other evidence of value:** Value of the shares is to be determined with reference to a "free" market. Thus, the court may properly consider evidence of the *directors' and officers' misconduct* if it lowered the value of the shares. [*Sturgeon Petroleums, Ltd. v. Merchants Petroleum Co.* (1983) 147 CA3d 134, 141, 195 CR 29, 33]

(e) [8:345] **Judgment:** Upon determining that the shares qualify as "dissenting shares," and their value as of the appropriate valuation date, the court will enter judgment requiring the corporation to purchase the dissenters' shares at such value. The judgment is payable only if the share certificates have been endorsed and delivered to the corporation. (But if the corporation has adopted uncertificated shares (¶ *5:472*), the judgment is payable "forthwith"—i.e., no delivery requirement.) [Corps.C. § 1305(c), (d)]

1) [8:346] **Interest:** The shareholder is entitled to interest at the legal rate from the date on which judgment is entered. (No prejudgment interest, however, except as provided below, ¶ 8:347 ff.) [Corps.C. § 1305(c)]

2) [8:347] **Costs:** If the value of the shares is determined to be no more than previously offered by the corporation, costs may be awarded or apportioned as the court deems just. [Corps.C. § 1305(e)]

[8:348] But if the appraised value of the shares is *more* than offered by the corporation, the shareholder is entitled to recover costs, including any appraisers' fees fixed by the court. [Corps.C. § 1305(e)]

[8:349] Moreover, if the value fixed by the court *exceeds 125%* of the price offered by the corporation, the court has discretion to award the shareholder's *attorney fees* and expert witness fees, *plus interest* at the legal rate on judgments (10%) from the date of the shareholder's demand and submission of shares for endorsement (¶ 8:329). [See Corps.C. § 1305(e)]

f. [8:350] **Effect of lack of lawful source for payment:** The statutory restrictions on a corporation's repurchasing its shares (Corps.C. § 500 et seq.) apply to purchases from dissenting shareholders in reorganizations. Thus, if the corporation lacks retained earnings or other net assets that lawfully can be used for share repurchases (*see* ¶ 7:10 ff.), the judgment or debt to the dissenting shareholders is not payable until the corporation acquires such funds. [Corps.C. § 1306]

In the meantime, such shareholders become *creditors* of the corporation—but their claims are *subordinate* to the claims of other creditors in the event of liquidation. [Corps.C. § 1306]

g. [8:351] **Effect of dividends paid:** Holders of dissenting shares retain all shareholder rights until determination of the value of their shares (¶ 8:352 ff.). Thus, they are entitled to any distributions paid by the corporation. However, any *cash* dividends paid by the corporation after shareholder approval of the reorganization are credited against the amount ultimately determined to be due for the dissenting shares. [Corps.C. §§ 1307, 1308]

h. [8:352] **Termination of dissenting share status:** "Dissenting shares" status ends upon occurrence of any of the following events:

• [8:353] The corporation *abandons* the reorganization. [Corps.C. § 1309(a)] (In such event, the corporation must reimburse dissenting shareholders for necessary expenses, including reasonable attorney fees, incurred in any good faith action to determine value, commenced in good faith by such shareholders; see Corps.C. § 1309(a).)

• [8:354] The dissenting shareholder, with the consent of the corporation, *withdraws* the demand that the corporation purchase the shares. [Corps.C. § 1309(d)]

• [8:355] The dissenting shareholder *transfers* the shares (before submitting them to the corporation for endorsement), or exercises conversion rights whereby they are converted to shares of a different class. [Corps.C. § 1309(b)]

• [8:356] The corporation and dissenting shareholder fail to agree on a price for the shares (or whether they qualify as "dissenting shares"), and neither sues within the *6-month limit* permitted for such actions (¶ *8:335*). [Corps.C. § 1309(c)]

• [8:357] The market value of the shares is *agreed upon* or *determined* by the court—at which time, the shareholders lose their status as such and become creditors for the amount due them. [Corps.C. § 1308]

i. [8:358] **Appraisal rights exclusive remedy:** Statutory appraisal rights are designed to be the exclusive remedy available to dissenting shareholders. A shareholder having the right to be "cashed out" (¶ 8:294 ff.) has no right to attack the validity of a proposed reorganization or short-form merger, or to have it set aside. [Corps.C. § 1312(a); *Steinberg v. Amplica, Inc.* (1986) 42 C3d 1198, 1208-1209, 233 CR 249, 255; *Busse v. United Panam Fin'l Corp.* (2014) 222 CA4th 1028, 1039-1050, 166 CR3d 520, 528-537 (citing text); *Singhania v. Uttarwar* (2006) 136 CA4th 416, 426, 38 CR3d 861, 868]

This is true even if the shareholder claims to have been defrauded by management and/or controlling shareholders in connection with the reorganization. [*Sturgeon Petroleums, Ltd. v. Merchants Petroleum Co.* (1983) 147 CA3d 134, 141, 195 CR 29, 33; *Steinberg v. Amplica, Inc.*, supra, 42 C3d at 1211-1212, 233 CR at 257 (approving *Sturgeon* where minority

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

shareholder waited to assert previously known claim until after merger consummated); *Busse v. United Panam Fin'l Corp.*, supra, 222 CA4th at 1046-1047, 166 CR3d at 534] (But the court may consider evidence of such fraud in determining the shares' appraisal value; *see ¶ 8:344*.)

[8:359 - 8:360] ***Reserved.***

(1) [8:361] **Exception—action to enforce special articles provision:** If the articles set forth the amount to be paid in respect to any class of shares in the event of a reorganization or short-form merger, such provisions control. A shareholder is entitled to enforce such right by appropriate action, without complying with the requirements for statutory appraisal rights. [Corps.C. §§ 1311, 1312(a)]

(a) [8:361.1] **Limitation—when merger or sale-of-assets agreement controls:** But the terms of a merger or sale-of-assets reorganization will control over the articles if they are approved by the same percentage of outstanding shares of the affected class (or series) as would be able to *amend* the articles provision to provide for payment of a different amount (*see ¶ 8:57 ff.*). [Corps.C. § 1312(a)]

(2) [8:362] **Exception—action to test validity of shareholder approval:** The Code specifically authorizes a dissenting shareholder to bring "an action to test whether the number of shares required to authorize or approve the reorganization or short-form merger were legally voted in favor thereof." [Corps.C. § 1312(a)]

(a) [8:363] **Application:** An action to test whether the shares were "legally voted" arguably might permit challenges such as whether the meeting was properly called, and proper notice given to all shareholders; whether there were adequate disclosures made in soliciting proxy votes; the validity of proxy votes, the correctness of the vote tallies, etc. [See *Singhania v. Uttarwar* (2006) 136 CA4th 416, 427, 38 CR3d 861, 868 (quoting text)]

However, such an action does *not* extend to such matters as alleged fraud, misrepresentation, forgeries, etc., in connection with obtaining approval of the reorganization. [*Sturgeon Petroleums Ltd. v. Merchants Petroleum Co.* (1983) 147 CA3d 134, 140, 195 CR 29, 32]

(b) [8:364] **Suspends other proceedings:** Such an action may be brought as an alternative to the exercise of statutory appraisal rights, and *suspends* all proceedings pending to determine the value of the dissenter's shares. It does not prejudice the shareholder's right to be cashed out if the action fails. [Corps.C. §§ 1310, 1312(a)]

(3) [8:365] **Exception—action to set aside reorganization not at "arm's length":** If one of the corporations in a reorganization or short-form merger is directly or indirectly controlled by the other (or both are under common control), there is an increased risk that the terms may be unfair to minority shareholders. Therefore, they are given *alternative* remedies: They may either assert their appraisal rights and be cashed out, *or* sue to enjoin or set aside the reorganization or short-form merger (on grounds of unfairness, breach of fiduciary duty, etc.). [Corps.C. § 1312(b); see *Busse v. United Panam Fin'l Corp.* (2014) 222 CA4th 1028, 1034, 1047-1050, 166 CR3d 520, 524, 534-537—shareholder who owned approximately 40% of target's stock (and who also controlled acquiring corporation) had effective control of target absent other major shareholders (citing text)]

(a) [8:366] **Either as bar to other; no damages action:** The remedies are mutually exclusive: Shareholders cannot sue to enjoin or set aside a reorganization if they have previously demanded payment for their shares. And, conversely, they cannot exercise appraisal rights after filing an action attacking the validity of the reorganization or short-form merger. In any event, minority shareholders cannot bring an action for damages against the "controlling" person (e.g., for breach of fiduciary duty). [Corps.C. § 1312(b); see *Busse v. United Panam Fin'l Corp.* (2014) 222 CA4th 1028, 1047-1050, 166 CR3d 520, 534-537 (citing text)]

(b) [8:367] **Burden of proof on controlling party:** In an action by a minority shareholder attacking the validity of a reorganization or short-form merger, the burden of proof is on the controlling party (parent corporation) to establish that the terms are "just and reasonable" to the shareholders of the controlled corporation (or of the corporations under common control). [Corps.C. § 1312(c)]

1) [8:367.1] **Compliance with special procedures for "controlling person" reorganizations:** New procedures governing reorganizations proposed by controlling persons should make it easier to satisfy these requirements. (See Corps.C. § 1203, *discussed at ¶ 8:172.5 ff.*)

(c) [8:368] **Relief available:** A court may either enjoin a proposed reorganization or short-form merger, or set it aside after it has been consummated. [Corps.C. § 1312(b)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

But injunctive relief can be granted only after 10 days' prior notice to the corporation (no immediate restraining orders), and only if the court finds that "*clearly no other remedy* will adequately protect the complaining shareholder or the class of which he is a member." [Corps.C. § 1312(b) (emphasis added)]

• [8:369] **Comment:** The purpose, of course, is to prevent a recalcitrant minority shareholder from holding up the transaction where the amount in dispute is relatively small and a damage award would be a fully adequate remedy.

(4) [8:370] **Compare—action under federal securities laws:** Even when statutory appraisal rights are the exclusive remedy under state law, a dissenting shareholder may be entitled to sue under certain provisions of the federal securities laws. For example:

(a) [8:371] **Anti-fraud rules:** A dissident shareholder may sue the corporation under SEC Rule 10b-5, for damages *or* injunctive relief, where management has made material misrepresentations or nondisclosures to the shareholders—notwithstanding the existence of appraisal rights under state law. [*Vine v. Beneficial Finance Co.* (2nd Cir. 1967) 374 F2d 627, 635]

(b) [8:372] **Proxy rules:** And, if material misstatements or omissions were made in the proxy solicitations for shareholder approval of the reorganization, an action for damages can be maintained under SEA § 14. A court has power thereunder to award damages, or even *set aside* (unwind) a corporate merger where shareholder approval was obtained by materially false proxy materials. [*J.I. Case Co. v. Borak* (1964) 377 US 426, 430-431, 84 S.Ct. 1555, 1559 (abrogation on other grounds recognized by *Ziglar v. Abbasi* (2017) 582 US 120, 131-132, 137 S.Ct. 1843, 1855)]

1) [8:372.1] **Causal nexus required between fraud and injury:** Shareholders suing for a violation of the federal proxy rules must show the violation *caused* their injury. Thus, where a majority shareholder already held sufficient shares to approve a cash-out merger, minority shareholders whose votes were solicited by a misleading proxy statement could not recover under SEA § 14(a) for damages allegedly resulting from the *merger* (i.e., proxy rule violations did not *cause* merger or plaintiff's damages because minority shareholder votes not needed for approval). [*Virginia Bankshares, Inc. v. Sandberg* (1991) 501 US 1083, 1102-1103, 111 S.Ct. 2749, 2763-2764]

However, the Supreme Court has reserved the question whether a cause of action may be maintained for a deceptive proxy statement that, by inducing shareholders to vote in favor of a merger, deprives those shareholders of their *state dissenters' appraisal rights.* [*Virginia Bankshares, Inc. v. Sandberg*, supra, 501 US at 1108, 111 S.Ct. at 2766, fn. 14] Lower courts have recognized a causal link between the misleading proxy statement and this type of injury, and thus have allowed a cause of action under § 14(a). [See, e.g., *Wilson v. Great American Indus., Inc.* (2nd Cir. 1992) 979 F2d 924, 930-931]

j. [8:372.2] **Waiver?** It is unclear whether a California corporation can enforce an advance waiver of dissenters' rights (¶ 8:292 ff.) against its shareholders because there is no California case law directly on point. Such waivers are enforceable for Delaware corporations. [*Manti Holdings, LLC v. Authentix Acquisition Co., Inc.* (Del. 2021) 261 A3d 1199, 1204, 1218-1221—Delaware corporation may enforce advance waiver of appraisal rights against sophisticated and informed stockholders who were represented by counsel and had bargaining power]

7. [8:373] **Divisive Reorganizations:** Under some circumstances, it may be desirable for a corporation to divide its existing business or assets into two or more separate corporations.

Typical reasons: to solve irreconcilable conflicts among the shareholders (as an alternative to dissolution); or to facilitate a sale and divestiture of just part of the business; or to insulate separable business activities from risks likely to be generated by the other (subject to "alter ego" limitations, *see ¶ 2:50 ff.*).

a. [8:374] **Forms of reorganization:** Dividing the corporation for these or any other reasons may be accomplished in one of three different ways: as a "*spin-off*," a "*split-off*," or a *"split-up."*

Each of these *may* be tax-free (*see ¶ 8:401*).

(1) [8:375] **Spin-off:** A spin-off occurs when a parent corporation distributes the stock of a subsidiary to its own shareholders pro rata *as a dividend*. As a result, those shareholders now own stock in two corporations. (The two corporations are now brother-sister, rather than parent-subsidiary.)

(a) [8:376] **Example:** P Corp. forms S Corp., and transfers part of its assets to S Corp. for all of the S Corp. stock. P Corp. then distributes the S Corp. stock pro rata to the P Corp. shareholders as a dividend, so that they now own all of the stock of both corporations.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(b) Procedural considerations

1) [8:377] **Formation:** Formation of the subsidiary (S Corp.) involves the same organizational requirements as any new corporation. Ordinarily, the officers of the parent (P Corp.) will act as the incorporators and initial directors.
2) [8:378] **Distributions limitations:** The dividend-in-kind to P Corp.'s shareholders is subject to the limitations applicable to corporate distributions to shareholders; i.e., P Corp. must have retained earnings or other sufficient net worth against which such a dividend can be charged (Corps.C. §§ 500-501, ¶ *7:10 ff.*).

(c) Securities law considerations

1) [8:379] **Federal law:** Ordinarily, a stock dividend does not involve a "sale" of a security under the Securities Act since the recipients provide no consideration for the stock dividend. [SA § 2(a)(3) ("sale" defined)]
a) [8:380] **Potential for abuse:** In the late 1960s, the SEC became concerned over the potential for abuse in spin-off transactions whereby unseasoned companies were spun off to the shareholders of a publicly owned company with the result that a trading market was created for the shares of the subsidiary with little or no information about the new company. The SEC challenged these transactions as involving the unregistered sale of securities. [See *SEC v. Datronics Engineers, Inc.* (4th Cir. 1973) 490 F2d 250, 253; and SEC Rel. No. 33-4962 (1969)]
b) [8:381] **Current SEC position:** Practitioners now generally follow the guidance set forth by the SEC staff. Under this guidance, the spin-off of the shares of a subsidiary by a company to its shareholders does *not* require registration if the following conditions are met:

• The parent's shareholders *provide no consideration* for the spun-off shares;

• The spin-off is *pro-rata* to the parent's shareholders;

• The parent provides a*dequate information* about the spin-off and the subsidiary to its shareholders and to the trading markets;

• The parent has a *valid business purpose* for the spin-off (¶ 8:381.1 ff.); and

• If the shares of the subsidiary are "restricted" securities (i.e., have not been registered), before the spin-off, the parent has held the securities for at least *two years* (but this condition does not apply where the parent *formed* the spun-off subsidiary rather than acquiring the business from a third party). [SEC Staff Legal Bulletin No. 4, 1997 WL 33831770, *2-4]

c) [8:381.1] **"Valid business purpose":** When there is a valid business purpose for a spin-off, it is less likely that the parent indirectly will receive value for the spun-off shares through the creation of a market in those shares (and thus the parent's shareholders will not be deemed to have provided consideration for the spun-off shares). [SEC Staff Legal Bulletin No. 4, 1997 WL 33831770, *4]
[8:381.2] **Examples:** A valid business purpose includes:

• Allowing management of each business to focus solely on that business;

• Providing employees of each business stock-based incentives linked solely to their employer;

• Enhancing access to financing by allowing the financial community to focus separately on each business; or

• Enabling the companies to do business with each other's competitors. [SEC Staff Legal Bulletin No. 4, 1997 WL 33831770, *4]
By contrast, there is *not* a valid business purpose when the purpose is:

• Creating a market in the spun-off securities without providing adequate information to the shareholders or the trading markets; or

• Creating a public market in the shares of a company that has minimal operations or assets, or that is a development stage company with no specific business plan or whose business plan is to engage in a merger or acquisition of an unidentified company. [SEC Staff Legal Bulletin No. 4, 1997 WL 33831770, *4]

d) [8:381.3] **Spun-off securities ordinarily not "restricted":** Ordinarily, securities received by shareholders in compliance with the conditions set forth at ¶ 8:381 are freely-trading (i.e., not "restricted"). [SEC Staff Legal Bulletin No. 4, 1997 WL 33831770, *5]

However, in rare situations where the spin-off decision is made by a *controlling shareholder* of the parent, the spin-off is viewed as a privately-negotiated transaction between the parent and that shareholder. That shareholder receives "restricted" securities, but the securities received by the other shareholders are freely-trading. [SEC Staff Legal Bulletin No. 4, 1997 WL 33831770, *6]

e) [8:382] **Spin-off disclosure statements:** Following the guidance of Staff Legal Bulletin No. 4, supra, spin-offs of subsidiaries where the parent is not closely-held would typically involve the preparation and distribution to the shareholders, in connection with the spin-off, of a Form 10 registration statement (the form used to register the shares of an issuer under the SEA) or, for nonpublic companies, a disclosure statement resembling a Form 10 registration statement. [17 CFR §§ 249.0-1, 249.210]

2) [8:383] **California law:** Under California law, a spin-off distribution by P Corp. to its stockholders is ordinarily *not* treated as a "sale for value" and thus not subject to qualification requirements. [Commr. Opns. Nos. 76/9C (1976 WL 3999), 72/141C (1972 WL 2949)]

On the other hand, the *initial* issuance of S Corp. shares to P Corp. would have to be qualified unless an exemption is available. The "limited offering" exemption (Corps.C. § 25102(f), ¶ *5:256*) *may* be available here. Arguably, as long as P Corp.'s *shareholders* meet the requirements of § 25102(f), P Corp. should be viewed as a mere conduit, so that its lack of requisite investment intent may be disregarded. [See Commr.Opn. 83/1C]

The P Corp. shares would also be exempt from qualification if they are distributed by a publicly held corporation to its shareholders and the P Corp. shares are listed or approved for listing on a national securities exchange. [Corps.C. §§ 25100(o), 25100.1(a)]

[8:384] ***Reserved.***

(2) [8:385] **Split-offs:** A split-off involves the same steps as a spin-off, except that the parent corporation's shareholders do not receive stock in the subsidiary as a dividend. Rather, they are offered such stock in *exchange* for a portion of their existing stock in the parent corporation. The effect is a *redemption* or repurchase of the parent corporation's stock, paid for with the stock of the subsidiary.

(a) [8:386] **Example:** P Corp. forms S Corp. and places part of its assets in S Corp. in return for all of S Corp.'s stock. P Corp. then offers the S Corp. stock to its stockholders in exchange for *some* of their stock in P Corp. After such exchange, there are two groups of stockholders: P stockholders who exchanged their stock for S Corp. stock and those who did not.

(b) [8:387] **Procedural considerations:** The corporate law considerations are much the same as with the spin-off (¶ 8:375 ff.). The only difference is that the final step (the exchange of stock in the subsidiary for some of the parent corporation's stock) is treated as a redemption or repurchase (rather than as a dividend-in-kind, in the spin-off).

1) [8:388] **Formation:** If the transfer of assets is to a new (rather than existing) subsidiary, the usual considerations on formation apply.

2) [8:389] **Distributions limitations:** The parent corporation's redemption or repurchase of a portion of its stock, in exchange for stock of its subsidiary, is subject to the same limitations and requirements of any other shareholder distribution (¶ *7:10 ff.*).

(c) [8:390] **Securities law considerations:** A split-off is treated as an "offer" and "sale" for value under both federal and California securities laws, as it involves a bargained-for exchange of shares. Thus, it is subject to registration and qualification requirements, unless an exemption is available.

1) [8:391] **Federal law:** A split-off will ordinarily have to be registered under the 1933 Act. The "private placement" and Reg. D exemptions are probably *not* available for the issuance of the subsidiary's shares to the parent, because

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

the parent (P Corp.) cannot satisfy the investment intent requirement. However, the "intrastate offering" exemption may potentially be available.

2) [8:392] **California law:** If the initial issuance by S Corp. to P Corp., and the later redistribution by P Corp. to its shareholders, are part of the same transaction, P Corp. will be treated as a mere conduit or "underwriter" under Corps.C. § 25022. Thus, the split-off will be exempt under the Corps.C. § 25102(f) "limited offering" exemption if P Corp.'s *shareholders* meet its requirements. [See Commr.Opn. 83/1C]

Comment: But P Corp. could not be regarded as a mere conduit where S Corp. was formed for some independent business purpose, and P Corp. has held its shares for a protracted period of time. In such a case, the initial issuance by S Corp. and subsequent split-off by P Corp. would be regarded as independent transactions.

Even so, if P Corp. is a publicly-held corporation and if S Corp.'s shares are listed or approved for listing on a national securities exchange, the S Corp. shares distributed to P Corp.'s shareholders would be exempt from qualification. [Corps.C. §§ 25100(o), 25100.1(a)]

[8:393] ***Reserved.***

(3) [8:394] **Split ups:** A split-up is similar to a spin-off (¶ 8:375) or split-off (¶ 8:385) but involves *liquidation of the parent* corporation. All of its assets are transferred to two or more subsidiaries in exchange for all of their stock. The parent corporation is then dissolved, and the subsidiaries' stock is distributed to its shareholders as a liquidating dividend.

(a) [8:395] **Example:** P Corp. forms two new subsidiaries, S1 Corp. and S2 Corp. It puts part of its assets in each of the subsidiaries, in return for their stock. P Corp. then dissolves. The S1 and S2 stock is distributed to the P Corp. shareholders as a liquidating dividend. (Usually, by agreement, some P shareholders get S1 stock and others get S2, so they are free to go their separate ways.) The result is that P Corp. no longer exists, and its assets are now held by two other corporations, owned by separate groups of former P shareholders.

(b) Procedural considerations

1) [8:396] **Formation:** If it is necessary to form new subsidiaries, the usual considerations on corporate formation apply. (*See ¶ 4:1 ff.*)

2) [8:397] **Shareholder approval required:** P Corp.'s shareholders must approve the split-up—not necessarily because it is a sale-of-assets reorganization (*see ¶ 8:262 ff.*), but rather because it involves *dissolution* and liquidation of P Corp. (See discussion of shareholder approval requirement on dissolution at *¶ 8:758*.)

3) [8:398] **Liquidation distribution:** The distribution of S1's and S2's stock in liquidation of P Corp. must comply with the requirements applicable to corporate liquidation (protection of creditors, etc.); *see ¶ 8:901 ff.*

(c) [8:399] **Securities law considerations:** Under either federal or California securities laws, the liquidating (split-up) distribution ordinarily will *not* be considered a "sale for value," and thus it is not subject to registration or qualification requirements. [See *National Petroleum Corp.,* Fed.Sec.Law.Rptr. 81,119 (1976 WL 11479, *11) (SEC No-Action Letter); and Commr.Opn. 72/131C (1972 WL 2940)]

However, problems similar to those discussed in connection with spin-offs (¶ 8:379 ff.) and split-offs (¶ 8:390 ff.) arise with regard to the initial issuances by S1 and S2 of their stock to P Corp.: i.e., presumably those initial issuances require registration under federal law unless some exemption *not* requiring "investment intent" by P Corp. is available (*see ¶ 8:391*). Under California law, P Corp. would presumably be viewed as a mere conduit so that the Corps.C. § 25102(f) limited offering exemption would be available if P Corp.'s *shareholders* satisfy all of its requirements (*see ¶ 8:392*). Alternatively, the S1 and S2 shares distributed by P Corp., if listed or approved for listing on a national securities exchange, would be exempt issuer securities under Corps.C. § 25100(a) and exempt "covered" securities under Corps.C. § 25100.1(a).

[8:400] ***Reserved.***

b. [8:401] **Tax treatment ("D reorganization"):** If the spin-off, split-off, or split-up meets the requirements below (¶ 8:402 ff.), it will be *tax-free* both to the corporations involved and to their shareholders. [IRC § 355] (A qualifying transaction is referred to as a "D reorganization" because it is described in IRC § 368(a)(1)(D).)

(1) [8:402] **Requirements:** First and foremost, a divisive "D" reorganization (as well as any other reorganization) must have a bona fide *business purpose*. [Treas.Reg. § 1.355-2(b); *Gregory v. Helvering* (1935) 293 US 465, 469-470, 55 S.Ct. 266, 267-268; *Commissioner v. Wilson* (9th Cir. 1965) 353 F2d 184, 186; see Rev.Rul. 2003-55, 2003-1 CB 961]

In addition, it must meet several, complex statutory tests which (at the risk of oversimplification) can be summarized briefly as follows:

(a) [8:403] **"Device" rule:** The transaction must *not* be used "principally as a device" for distribution of earnings and profits of either parent or subsidiary corporations. [IRC § 355(a)(1)(B); see Prop.Treas.Reg. § 1.355-9]

1) [8:404] **Example:** If the S Corp. shares are *sold* immediately after the reorganization, a court is likely to find that the reorganization was merely a "device" for bailing out P Corp.'s earnings and profits as a capital gain—particularly if the sale was planned before the reorganization. [See *Gregory v. Helvering* (1935) 293 US 465, 469-470, 55 S.Ct. 266, 267-268; *South Tulsa Pathology Laboratory, Inc. v. Commr.* (2002) 118 TC 84]

(b) [8:405] **Distribution of control:** The parent corporation must have had control of the subsidiary corporation or corporations, and must have distributed such control to its own stockholders. There are two separate requirements:

• [8:406] **Solely stock or securities:** First, P Corp. must be distributing to its shareholders *solely* stock or securities of a *controlled* subsidiary. [IRC § 355(a)(1)(A)] ("Control" is defined in the usual way for tax purposes; i.e., ownership of at least 80% of the voting shares and of each class of nonvoting stock; see IRC § 368(c) and Rev.Rul. 59-259, 1959-2 CB 115.)

• [8:407] **At least 80%:** Second, P Corp. must distribute all of the subsidiary's stock; or if not, *at least 80%* thereof (i.e., control), and show the IRS a valid business purpose—other than tax avoidance—for retaining the balance. [See IRC § 355(a)(1)(D)]

(c) [8:408] **Five-year active business:** Except for split-ups (where the parent corporation is dissolved), both parent and subsidiary corporations must continue to be engaged in active conduct of a trade or business after the reorganization; *and* those businesses must have been carried on for *at least five years before* the reorganization. [IRC § 355(b); see Prop.Treas.Reg. § 1.355-9]

1) [8:409] **"Passive" business distinguished:** The "active business" requirement means what it says: i.e., an active trade or business, as opposed to passive investments. Thus, a reorganization is not tax-free where the assets transferred to a subsidiary are rented out or leased to others on a net rental basis, because rental activity is *not* an "active business." [Treas.Reg. § 1.355-3(b)(2)(iv); *Bonsall v. Commr*. (2nd Cir. 1963) 317 F2d 61, 64-65]

2) [8:409.1] **Spin-off of business acquired during five-year period ("expansion doctrine"):** If a corporation that engaged in the active conduct of a trade or business during the five-year period purchased, created or otherwise acquired another company in the *same line of business*, the acquisition is deemed an *expansion* of the original business, and the entire combined business is treated as having been actively conducted during the five-year period. [Treas.Reg. § 1.355-3(b)(3)(ii), (c); see Rev.Rul. 2003-38, 2003-1 CB 811—long-time retailer's spin-off of 2-year-old Internet sales business qualified as tax-free under expansion doctrine; *Athanasios v. Commr*., TC Memo 1995-72]

(2) [8:410] **Gain or loss computations:** If a spin-off, split-off, or split-up qualifies as a "D reorganization," no gain or loss is recognized to either corporation or to the shareholders at the time of transaction. [IRC § 355]

(a) [8:411] **Carryover basis:** The assets transferred to the subsidiary corporation retain the same basis as when held by the parent corporation. [IRC § 362(b)]

Likewise, the parent corporation's shareholders take the basis of the surrendered shares in the stock they receive. (Where they have stock in both parent and subsidiary corporations, as in a spin-off, the basis on the old stock is apportioned in accordance with fair market values; *see ¶ 7:284*.) [IRC § 358(a)]

(b) [8:412] **Taxability of "boot":** Of course, if cash or property other than securities of the subsidiary is distributed, the subsidiary will recognize gain (but not loss) on the appreciation of such property. [IRC § 361; *see ¶ 8:282.2*] The distribution will also be taxable to the recipient shareholders. [IRC § 356(a)]

1) [8:412a] **"Nonqualified preferred stock" as "boot":** Here again, "nonqualified preferred stock" (*¶ 3:340.1 ff.*) is treated as "boot" (unless received for other "nonqualified preferred stock"). [IRC §§ 354(a)(2)(C)(i), 356(e)]

(c) [8:412.1] **Exception—corporate gain recognized upon certain stock distributions/sales:** Special rules prevent the corporation from using a "D reorganization" as a vehicle to *sell* a business without recognizing gain. Absent such

rules, taxable gain could be avoided where, for example, a parent distributes to its shareholders stock in a subsidiary that has appreciated substantially and the distribution is followed by a prearranged sale of the stock to a third party.

Under a complex set of rules, a corporation recognizes gain on distribution of a subsidiary's stock or securities if, immediately after the distribution, a shareholder (or group of related shareholders) holds a 50% or greater interest in either the subsidiary or distributing corporation and such interest is attributable to stock or securities (of either corporation) acquired by *purchase* within a specified period of time (either the preceding five years or, alternatively, the preceding two years or following two years, depending upon the circumstances). In such event, the corporation recognizes gain as if it *sold* the subsidiary's stock at *fair market value*. [See IRC § 355(c),(d),(e); Treas.Reg. § 1.355-7]

(d) [8:413] **Compare—nonqualifying transactions:** Of course, if a spin-off, split-off, or split-up fails to qualify as a “D reorganization,” it will be subject to normal rules governing distributions to shareholders: i.e., a spin-off would be taxable as a dividend in kind (*¶ 7:178*); a split-off would be taxable as a redemption or repurchase of shares (*¶ 7:228*); and a split-up would be taxable as a distribution in complete liquidation (*¶ 8:1152*).

(3) [8:413.1] **California property tax reassessment:** A “D” reorganization may result in a “change of ownership” of the involved corporations' real property, thus triggering reassessment for property tax purposes. [*Pueblos del Rio South v. City of San Diego* (1989) 209 CA3d 893, 899-908, 257 CR 578, 581-588; *see ¶ 8:118.20*]

(4) [8:413.2] **Application of documentary transfer tax:** A change in the beneficial ownership of a majority interest in an entity owning real property may also trigger imposition of a documentary transfer tax. *See ¶ 8:118.20a*.

8. [8:414] **Other Nontaxable Reorganizations:** “A mere change in the identity, form or place of organization of one corporation, however effected” is a tax-free “F” reorganization. [IRC § 368(a)(1)(F); see Treas.Reg. § 1.368-2(m)]

(For corporate law purposes, however, such changes are *not* treated as “reorganizations” and thus not subject to shareholder approval and other procedural requirements. See Corps.C. § 181(a); see also Corps.C. § 2511 (SPCs).)

[8:415] ***Reserved.***

[8:416] A mere change in a corporation's name, form or place of organization are tax-free because they do not result in (and usually are not for the purpose of) tax avoidance. [See Treas.Reg. 1.368-2(m); 26 CFR § 1.368.2]

For example, a California corporation, wishing to become a Delaware corporation, forms a Delaware subsidiary into which it merges (or to which it transfers all its business and assets in exchange for stock and securities, which it then distributes to its shareholders in liquidation). Such a reorganization would potentially qualify as a tax-free “F reorganization.”

[8:417] But a transaction will not be tax-free if it results in a shift in *ownership*. [See *Russell v. Commr.* (6th Cir. 1987) 832 F2d 349, 352-353]

[8:418 - 8:450] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 8-C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

C. Conversions

1. Conversion From Corporation Into Another Domestic or Foreign Entity
- a. [8:452] Entities into which corporation may convert
  - (1) [8:452a] "Other business entity" defined
  - (2) [8:452.1] Conversion into foreign entity
  - (3) [8:452.2] Compare—"conversion" (change of status) into or from SPC
  - (4) [8:452.3] Compare—"conversion" (change of status) into or from benefit corporation
- b. [8:453] Plan of conversion
  - (1) [8:454] Manner of converting shares
    - (a) [8:455] Equal treatment unless all shareholders consent
    - (b) [8:456] Nonredeemable shares
  - (2) [8:457] Converted entity's governing documents
- c. [8:470] Board approval
- d. [8:471] Shareholder approval
  - (1) [8:472] Two-thirds approval in statutory close corporation
  - (2) [8:472.1] Two-thirds approval in SPC
  - (3) [8:472.2] Conversion of benefit corporation
  - (4) [8:473] Dissenters' rights
    - (a) [8:474] Additional approval required where no dissenters' rights
  - (5) [8:475] Nondissenting shareholder deemed party to new entity's governing documents
- e. Amending or abandoning plan
  - (1) [8:481] Amendment
  - (2) [8:482] Abandonment
- f. [8:483] Filing of statement or certificate of conversion; effective date
  - (1) Appropriate form for converted entity
    - (a) [8:484] General partnership
    - (b) [8:485] Limited partnership
    - (c) [8:486] Limited liability company
  - (2) [8:488] Execution by corporate officers
  - (3) [8:489] No certificate of dissolution required
- g. [8:490] Effect of conversion—continuation of assets and liabilities
  - (1) [8:490.1] Nondissenting shareholder deemed party to new entity's governing documents
  - (2) [8:491] Shareholder's postconversion liabilities
  - (3) [8:492] Automatic assumption of tax liability by converted entity

h. Postconversion procedural requirements
(1) [8:501] Notice to creditors
(2) [8:502] Record title to real property
(3) [8:503] Plan of conversion available to former shareholders
i. [8:504] Tax consequences—*taxable gain (or loss) recognized by corporation AND shareholders*
j. [8:510] Securities law considerations
(1) [8:510.1] Federal law
(2) [8:511] California law
(a) [8:512] "Securities"
(b) Exemptions
1) [8:513] Preconversion negotiations
2) [8:514] "Nonresidents" exemption
3) [8:515] "Limited exchange" transaction
(c) [8:519] Qualification procedure
k. [8:520] Secretary of State as agent for service of process on converted foreign corporation or foreign other business entity
(1) [8:521] Service on California Secretary of State
(2) [8:522] Service by California Secretary of State on foreign entity
2. [8:531] Conversion From Noncorporate Entity or Foreign Corporation Into California Corporation
a. [8:532] California law authorizing conversion
b. [8:533] Approval of plan of conversion
(1) [8:533.1] Conversion into benefit corporation
c. [8:534] Filing of statement of conversion; effective date
(1) [8:535] Additional requirements for foreign entities
d. [8:536] Effect of conversion on entity
(1) [8:537] Effect on former partner's liabilities
e. [8:538] Tax consequences—potential nonrecognition of taxable gain (or loss)
(1) [8:538.1] S corporation election to avoid intervening C corporation
(a) [8:538.2] Comment
f. [8:539] Securities law considerations
(1) [8:539.1] Federal law
(2) [8:539.2] California law
g. [8:540] Personal liability for unlawful conversion

[8:451] There are circumstances in which a business entity may desire to change its *form* of organization—i.e., convert from a corporation into a limited partnership or a limited liability company ("corporate conversion"), or from a partnership or limited liability company into a corporation ("other entity conversion").

For example, a corporation may wish to convert to a "pass-through entity" to avoid "double taxation" or to allow the owners to take advantage of near-term losses.

Conversely, a partnership or limited liability company may want to operate as a corporation for a number of reasons:

• The business has become profitable and the owners do not want the tax liabilities resulting from a pass-through of profits;

• Institutional investors prefer the corporate form for making equity investments; or

• The business desires to engage in a public offering of its securities.

Prior to the enactment of statutes permitting conversions, the only way for an entity to transform itself was by a two-step process of forming the new entity and then engaging in a merger or asset contribution. Now, streamlined procedures permit an entity simply to convert into another entity (Corps.C. § 1150 et seq.; see also Corps.C. § 3300 et seq. (SPCs)).

Compare: A corporation may wish to operate as an SPC or benefit corporation to more easily pursue environmental or "social" objectives. Such a "conversion" is treated as a *change of status* that must be made by way of a *merger* or an *articles amendment*. *See ¶ 8:452.2 ff.*

1. Conversion From Corporation Into Another Domestic or Foreign Entity

a. [8:452] **Entities into which corporation may convert:** A California (or foreign) corporation may convert into another *domestic* other business entity, foreign other business entity, or foreign corporation ("corporate conversion") so long as:

• The corporation complies with all laws applicable to the conversion; and

• The law under which the resulting entity will exist expressly permits its formation by such conversion. [Corps.C. § 1151(b)]

(1) [8:452a] **"Other business entity" defined:** "Other business entity" is broadly defined to encompass a variety of entities, including a domestic or foreign limited liability company, limited partnership, general partnership, business trust, real estate investment trust, unincorporated association (other than a nonprofit association), or a domestic reciprocal insurer organized after 1974 to provide medical malpractice insurance. [Corps.C. § 174.5]

(2) [8:452.1] **Conversion into foreign entity:** The Code allows corporations to convert into foreign corporations or other business entities. Corporations are not limited to converting to domestic entities. [See Corps.C. §§ 1150(c), 1151(b)]

(3) [8:452.2] **Compare—"conversion" (change of status) into or from SPC:** Until 2015, several Code provisions (now repealed) contemplated conversion of a nonSPC corporation (including a benefit corporation) into an SPC (then known as a flexible purpose corporation) and, conversely, conversion of an SPC into a nonSPC corporation (including a benefit corporation). However, there were some concerns arising from apparent drafting errors in other Code provisions, causing attorneys to avoid the conversion procedures. [See former Corps.C. §§ 1152(d), 1155(a)(4), (e), 3304(a)(4)]

There are now *no* procedures allowing a nonSPC corporation to convert to an SPC or allowing an SPC to convert into a nonSPC corporation. However, a nonSPC corporation (including a benefit corporation) can *change its status* to an SPC, and an SPC can *change its status* to a nonSPC corporation (including a benefit corporation) by way of a *merger* (*see ¶ 8:176.1 ff., 9:56*) or—more expeditiously—an *articles amendment* (*see ¶ 8:25.1, 9:276*). Further, an SPC and benefit corporation may *not* convert into a foreign corporation or foreign other business entity. [See Corps.C. § 3300 et seq.]

(4) [8:452.3] **Compare—"conversion" (change of status) into or from benefit corporation:** Similarly, the statutory conversion provisions (Corps.C. § 1150 et seq.), which apply to both nonbenefit corporations and benefit corporations (*see ¶ 9:500)*, do not allow for conversion of a nonbenefit corporation into a benefit corporation; nor do they allow a benefit corporation to convert into a nonbenefit corporation. But here again, a corporation (including an SPC) may *change its status* into a benefit corporation, or a benefit corporation may *change its status* to a nonbenefit corporation (including an SPC), by way of a *merger* (*¶ 8:176.1 ff., 9:535*) or—more expeditiously—an *articles amendment* (*see ¶ 8:25.2, 9:531, 9:662*).

b. [8:453] **Plan of conversion:** The corporation must approve a plan of conversion stating (1) the terms and conditions of conversion; (2) the converted entity's name, form, and jurisdiction of organization after conversion; (3) the manner of converting the converting corporation's shares into securities of, or interests in, the converted entity (*see ¶ 8:454 ff.*); (4) the provisions of the converted entity's governing documents to which the holders of interests in the converted entity will be bound, as specified (*see ¶ 8:457*); and (5) any other details or provisions required by the laws under which the converted entity is organized or that the converting corporation desires. [Corps.C. § 1152(a)]

(1) [8:454] **Manner of converting shares:** The plan must state the manner of converting the shares of each shareholder into securities of or interests in the converted entity. [Corps.C. § 1152(a)(3); see also Corps.C. § 3302(a)(3) (SPCs)]

(a) [8:455] **Equal treatment unless all shareholders consent:** As under the merger statutes (*¶ 8:177 ff.*), unless *all holders of the class or series consent*, each share of the same class or series must be *treated equally* with respect to any cash, rights, securities or other property to be received by, or any obligations or restrictions to be imposed on, the holder of that share. (But this does not restrict the shareholders' ability to appoint one or more general partners or managers of the converted entity, either in the plan of conversion or the converted entity's governing documents.) [Corps.C. § 1151(a); see also Corps.C. § 3301(a) (SPCs)]

(b) [8:456] **Nonredeemable shares:** The corporation's nonredeemable common shares may be converted only to nonredeemable equity securities of the converted entity unless *all* of the shareholders of the class consent otherwise. [Corps.C. § 1151(a); see also Corps.C. § 3301(a) (SPCs)]

(2) [8:457] **Converted entity's governing documents:** The plan must set forth the provisions of the converted entity's governing documents to which the holders of ownership interests are to be bound. For partnerships, this includes the partnership agreement. For limited liability companies, this includes the articles of organization or certificate of formation and operating agreement. For corporations, this includes the articles or certificate of incorporation. [Corps.C. § 1152(a)(4)]

[8:458 - 8:469] ***Reserved.***

c. [8:470] **Board approval:** The plan of conversion must be approved by the converting corporation's board of directors. [Corps.C. § 1152(b); see also Corps.C. § 3302(b) (SPCs)]

d. [8:471] **Shareholder approval:** The principal terms of the plan must also be approved, before or after the board action (¶ 8:470), by affirmative vote of a *majority* of each class or series of the outstanding shares entitled to vote (or such *greater* vote as may be required by the corporation's articles). [Corps.C. § 1152(b)]

(1) [8:472] **Two-thirds approval in statutory close corporation:** If the converting corporation is a statutory close corporation (*¶ 3:233 ff.*), the conversion must be approved by affirmative vote of at least two-thirds of each class of outstanding shares, unless the articles provide for a greater or lesser vote (but the articles may not permit approval by less than a majority of each class of outstanding shares). [Corps.C. § 1152(b)]

(2) [8:472.1] **Two-thirds approval in SPC:** If an SPC is converting into another (noncorporate) entity, the conversion must be approved by affirmative vote of at least two-thirds of each class of outstanding shares (unless the articles provide for a greater vote) regardless of whether the articles entitle that class to vote thereon. [Corps.C. § 3302(b); *see ¶ 9:322*]

(3) [8:472.2] **Conversion of benefit corporation:** A conversion of a benefit corporation into another entity must be approved by *two-thirds* of the outstanding shares of each class or series of stock (or any greater amount required by the articles) regardless of any limitation stated in the articles or bylaws on the voting rights of any class or series. [Corps.C. § 14604(c); see Corps.C. § 14601(d)(1), *¶ 9:537*]

(4) [8:473] **Dissenters' rights:** Dissenters' rights apply in a corporate conversion as in any acquisitive “reorganization.” Thus, shareholders who qualify for dissenters' rights may be “cashed out” for the appraised value of their shares. (A conversion is deemed a “reorganization” solely for the purpose of applying dissenters' rights.) [Corps.C. §§ 1159, 1313; see also Corps.C. §§ 3302(b), 3305 (SPCs)]

Cross-refer: See detailed discussion of dissenters' rights at ¶ 8:292 ff.

(a) [8:474] **Additional approval required where no dissenters' rights:** If the corporation is converting into a general or limited partnership or foreign general or limited partnership, or a limited liability company or foreign limited liability company, in addition to the shareholder approval described above (¶ 8:471 ff.), the conversion must be approved by each shareholder who will become a *general partner* or *manager* of the converted entity and who does not have dissenters' rights. [Corps.C. § 1152(c); see also Corps.C. § 3302(c) (SPCs)]

(5) [8:475] **Nondissenting shareholder deemed party to new entity's governing documents:** Upon effectiveness of the conversion (¶ 8:483), all shareholders who did not exercise dissenters' rights (¶ 8:473) are deemed parties to any agreement(s) constituting the governing documents for the converted entity that were adopted as part of the plan of conversion (regardless of whether the shareholder executed the plan of conversion or such documents). [Corps.C. § 1152(d); see also Corps.C. § 3302(d) (SPCs)]

➪ [8:476] ***PRACTICE POINTER:*** To avoid future disputes, each shareholder who will be a general partner or manager of the converted partnership or limited liability company should *sign* the plan of conversion, indicating acceptance of such position or otherwise give *written* approval to the conversion.

[8:477 - 8:480] ***Reserved.***

e. Amending or abandoning plan

(1) [8:481] **Amendment:** The plan of conversion may be amended *before the conversion takes effect* (¶ 8:483). However, the amendment must be approved by the board. And if the amendment changes any of the *principal terms* of the plan,

it must be approved by the shareholders in the same manner and to the same extent as was required for approval of the original plan. [Corps.C. § 1152(e); see also Corps.C. § 3302(e) (SPCs)]

(2) [8:482] **Abandonment:** Subject to any contractual rights of third parties, the plan of conversion may be abandoned any time *before the conversion becomes effective* (¶ 8:483) by approval of *either* the board *or* the outstanding shares, in each case in the same manner as required for approval of the plan. [Corps.C. § 1152(f); see also Corps.C. § 3302(f) (SPCs)]

f. [8:483] **Filing of statement or certificate of conversion; effective date:** The converting entity must file with the Secretary of State "all documents required by law … to effect the conversion and create the converted entity." In the case of a corporation converting into a foreign corporation or foreign other business entity, this includes all documents required by the laws of the entity's state or place of organization. [Corps.C. § 1153(a)]

The filed documents *must include* a certificate or statement of conversion *on the form prescribed by the Secretary of State* (*see ¶ 8:484 ff.*), which must set forth:

- The name and Secretary of State's filing number of the converting corporation;

- A statement of the total number of outstanding shares of each class entitled to vote on the conversion and that the principal terms of the plan of conversion were approved by a vote of the number of shares of each class that equaled or exceeded the required vote (*see ¶ 8:471 ff.*), specifying each class and the percentage vote required of each class;

- The converted entity's name, form and jurisdiction of organization (i.e., California, *see ¶ 8:452*); and

- The name, mailing address, and street address of the converted entity's agent for service of process (but the address should not be set forth if the agent is a corporation that has filed a certificate with the Secretary of State designating its offices and employees who can be served within California (per Corps.C. § 1505)). [Corps.C. §§ 1153(a), 1155(b), (c); see also Corps.C. §§ 3303(a), 3304(b) & (c) (SPCs)]

The conversion is effective upon the Secretary of State's filing of the certificate or statement of conversion … unless the certificate or statement sets forth a delayed effective date pursuant to Corps.C. § 110(c). In the case of a corporation converting into a foreign corporation or foreign other business entity, the conversion is effective in accordance with the laws of the entity's state or place of organization. [Corps.C. § 1153(a)]

(1) Appropriate form for converted entity

(a) [8:484] **General partnership:** If the corporation is converting into a *general partnership,* the statement of conversion must be included in the *statement of partnership authority* and, if none, a certificate of conversion must be filed separately. [Corps.C. § 1155(a)(2); see also Corps.C. § 3304(a)(2) (SPCs)]

FORMS

- The Secretary of State's standard form General Partnership Statement of Partnership Authority—Conversion (GP-1A) is available online at the Secretary of State's website (*www.sos.ca.gov*).

- The Secretary of State's standard form Certificate of Conversion (CONV-1A) is available online at the Secretary of State's website (*www.sos.ca.gov*).

(b) [8:485] **Limited partnership:** If the corporation is converting into a *limited partnership*, the statement of conversion must be included in the *certificate of limited partnership* being filed for the converted entity. [Corps.C. § 1155(a)(1); see also Corps.C. § 3304(a)(1) (SPCs)]

FORM: The Secretary of State's standard form Certificate of Limited Partnership—Conversion (LP-1A) is available online at the Secretary of State's website (*www.sos.ca.gov*).

(c) [8:486] **Limited liability company:** If the corporation is converting into a *limited liability company*, the statement of conversion must be included in the *articles of organization*. [Corps.C. § 1155(a)(3); see also Corps.C. § 3304(a)(3) (SPCs)]

FORM: The Secretary of State's standard form Limited Liability Company Articles of Organization—Conversion (LLC-1A) is available online at the Secretary of State's website (*www.sos.ca.gov*).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[8:487] **Foreign corporation or foreign other business entity:** If the corporation is converting into a foreign corporation or foreign other business entity, a certificate of conversion must be filed with the Secretary of State. [Corps.C. § 1155(a)(4)]

(2) [8:488] **Execution by corporate officers:** The statement or certificate of conversion must be executed and acknowledged by the chairperson of the board, president or any vice president *and* by the secretary, chief financial officer, treasurer or any assistant secretary or assistant treasurer of the corporation. [Corps.C. § 1155(b); see Corps.C. § 173; see also Corps.C. § 3304(b) (SPCs)]

(3) [8:489] **No certificate of dissolution required:** The filing of a certificate or statement of conversion with the Secretary of State has the effect of the filing of a certificate of dissolution by the converting corporation. Thus, the converting corporation is not required to file a certificate of election to dissolve or a certificate of dissolution. [Corps.C. § 1155(d)]

g. [8:490] **Effect of conversion—continuation of assets and liabilities:** The converted entity is for all purposes—*except franchise and personal income taxation*—the *same entity* that existed before the conversion. Thus, upon effectiveness of the conversion:

• All of the corporation's rights and property, whether real, personal or mixed, are vested in the converted entity (except for the *record title to real property*, *see* ¶ *8:502*);

• All of the corporation's debts, liabilities and obligations continue as debts, liabilities and obligations of the converted entity;

• All rights of creditors and liens on the corporation's property are preserved unimpaired and remain enforceable against the converted entity; and

• Any action or proceeding by or against the corporation may be continued against the converted entity. [Corps.C. § 1158(a), (b)]

(1) [8:490.1] **Nondissenting shareholder deemed party to new entity's governing documents:** *See* ¶ *8:475*.

(2) [8:491] **Shareholder's postconversion liabilities:** Following conversion, a shareholder remains personally liable for any *corporate* obligations to the same extent as before the conversion. [Corps.C. § 1158(c)(1), (d)]

The shareholder is also liable for all obligations of the *converted entity* if the shareholder becomes a *general partner* of the converted entity or a holder of other interests that entail personal liability under the converted entity's governing documents or the laws under which it is organized. [Corps.C. § 1158(c)(2)]

(3) [8:492] **Automatic assumption of tax liability by converted entity:** Upon the effectiveness of the conversion, a converted entity is “deemed to have assumed” the converting corporation's liability to file all California franchise tax and information returns otherwise required and to pay any franchise tax liability determined to be due. [Corps.C. § 1155(e); see also Corps.C. § 3304(e) (SPCs)]

[8:493 - 8:500] ***Reserved.***

h. Postconversion procedural requirements

(1) [8:501] **Notice to creditors:** Within 90 days after the conversion's effective date (*see* ¶ *8:483*), the converted entity must give written notice of the conversion by mail to all known creditors and claimants whose addresses appear on the corporation's records. (But failure to do so does not affect the validity of the conversion or the rights of a creditor or claimant.) [Corps.C. § 1158(f)]

(2) [8:502] **Record title to real property:** The filing for record, in the office of the county recorder of any California county in which any of the corporation's real property is located, of a statement or certificate of conversion, certified on or after the conversion's effective date by the Secretary of State, *evidences record ownership* in the converted entity of all of the converting corporation's interest in the real property. Such recordation creates, in favor of bona fide purchasers or encumbrances for value, a *conclusive presumption* that the conversion was *validly completed*. [Corps.C. § 1156(a), (c)]

(3) [8:503] **Plan of conversion available to former shareholders:** The converted entity must keep the plan of conversion at the following location, as applicable (Corps.C. § 1152(g)):

• if a domestic general partnership, at its principal place of business;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- if a domestic limited partnership or limited liability company, at the office at which it must keep its records under the Code; or

- if a foreign other business entity or a foreign corporation, at the office at which records are to be kept under the laws of the jurisdiction applicable to the converted entity.

  The converted entity must also deliver, at its own expense, a copy of the plan to any requesting shareholder of the converting corporation. Any purported waiver by a shareholder of these rights is unenforceable. [Corps.C. § 1152(g); see also Corps.C. § 3302(g) (SPCs)]

i. [8:504] **Tax consequences—*taxable gain (or loss) recognized by corporation AND shareholders:*** A corporation's conversion into a partnership or limited liability company is treated as a liquidating distribution of the corporation's assets (subject to its liabilities) to the shareholders (i.e., a dissolution), followed by a contribution of such assets (subject to liabilities) to the converted entity. As a result:

- The corporation generally recognizes gain (or loss) on the distribution to the extent the fair market value of the assets is greater (or less) than the corporation's basis in the assets; and the shareholders generally recognize gain (or loss) to the extent the value of the distributed assets is greater (or less) than the shareholders' basis in their stock (*see ¶ 8:1151 ff.*). [IRC §§ 331, 336]

- But the subsequent contribution to the converted entity is generally *tax-free*, with the assets retaining the same basis in the hands of the entity that they had in the hands of the shareholders immediately following the distribution (*see ¶ 2:158*). [IRC § 721]

[8:505 - 8:509] ***Reserved.***

j. [8:510] **Securities law considerations:** A conversion is treated as a statutory *merger* for securities law purposes.

Reason: Like a merger, a conversion requires shareholder approval and a decision whether to accept new securities in a different type of entity. Also, a conversion can be approved by vote of less than all the shareholders over the objection of a minority, whose remedy is generally limited to dissenters' rights.

(1) [8:510.1] **Federal law:** *See discussion at ¶ 8:226 ff.*

(2) [8:511] **California law:** A conversion into an entity having ownership interests that constitute “securities” (¶ 8:512) will require qualification … unless the conversion is exempt or federally preempted (*see ¶ 5:18.5 ff.*). [Corps.C. §§ 25005.1, 25120(a)(4)]

(a) [8:512] **“Securities”:** Ordinarily, a *general partnership* interest is not a “security.” But the interest of a “passive” general partner may constitute a “security.” *See ¶ 5:40 ff.*

Similarly, *LLC* membership interests are securities *unless all members actively engage in management*. [Corps.C. § 25019; ¶ 5:41.1]

Thus, conversion into a closely-held general partnership or LLC in which all partners or members participate in management will not require qualification.

In contrast, *limited partnership* interests are usually “securities” (*see ¶ 5:41*); thus, conversion into a limited partnership will usually require qualification (unless exempt, ¶ 8:513 ff.).

(b) Exemptions

1) [8:513] **Preconversion negotiations:** Negotiations and agreements prior to soliciting shareholder approval for the conversion are exempt from qualification. [Corps.C. § 25103(a); *see ¶ 8:230*]

2) [8:514] **“Nonresidents” exemption:** This is similar to the “nonresidents” exemption applicable to mergers (¶ 8:231). The conversion will not require qualification so long as California residents hold *less than 25%* of the *outstanding* shares of any class that will be directly or indirectly affected *substantially and adversely* by the conversion. [Corps.C. § 25103(b), (d)]

For purposes of this exemption, shares are *not* considered "outstanding" if they are known to be held in the names of broker-dealers (or their nominees), or are held by any person controlling 50% or more of the class. [Corps.C. § 25103(d)(1), (2)]

3) [8:515] **"Limited exchange" transaction:** The so-called "limited exchange transaction" exemption is applicable to conversions. [Corps.C. § 25103(h); *see* ¶ *8:232.1 ff.*]

[8:516 - 8:518] ***Reserved.***

(c) [8:519] **Qualification procedure:** If the corporation converts into an entity having "securities" and no exemption is available, the conversion must be qualified by permit from the Financial Protection and Innovation Commissioner. The procedure for obtaining a permit is the same as discussed in connection with recapitalizations and mergers (¶ 8:157 ff.). [Corps.C. § 25121; Commr. Rule 260.121]

k. [8:520] **Secretary of State as agent for service of process on converted foreign corporation or foreign other business entity:** In an action or proceeding against a converted foreign corporation or foreign other business entity to enforce an obligation of the converting corporation, the California Secretary of State may be the converted entity's agent for service of process only when it is shown that no other agent could be found after a diligent search.

Specifically, the party seeking to serve the converted entity must show by affidavit satisfactory to the court that:

- if the designated agent for service of process is a natural person, the agent cannot be found with due diligence;
- if the designated agent for service of process is a corporation, no person to whom delivery may be made can be located with due diligence; or
- if no agent has been designated, none of the entity's officers, members, managers, or agents of the entity can be located after diligent search. [Corps.C. § 1154(a)]

(1) [8:521] **Service on California Secretary of State:** Upon a satisfactory showing (¶ 8:520*)*, the court may order that service may be made by *personal delivery* to the California Secretary of State (or to an assistant or Deputy Secretary of State) of two copies of the process together with two copies of the order. The order must set forth the address to which the Secretary of State is to send the process.

Service in this manner is deemed complete on the 10th day after delivery of process to the Secretary of State. [Corps.C. § 1154(a)]

(2) [8:522] **Service by California Secretary of State on foreign entity:** Upon receipt of process and the applicable fee, the Secretary of State must provide notice to the foreign entity of the service of process by forwarding (by certified mail, return receipt requested) a copy of the process and the court's order to the specified address. The Secretary of State is required to keep a record of all process served upon it and all actions taken by it. The Secretary of State's certificate certifying (a) the receipt of process, (b) the providing of notice of process to the foreign entity, and (c) the forwarding of the process shall be competent and prima facie evidence of the matters stated. [Corps.C. § 1154(b), (c)]

[8:523 - 8:530] ***Reserved.***

2. [8:531] **Conversion From Noncorporate Entity or Foreign Corporation Into California Corporation:** A domestic other business entity, foreign other business entity, or foreign corporation may convert into a California corporation so long as the converting entity is authorized by the laws under which it is organized to effect such a conversion. [Corps.C. § 1157(a); see also Corps.C. § 3307(a) (SPCs)]

a. [8:532] **California law authorizing conversion:** California law governing general partnerships, limited partnerships and limited liability companies expressly authorizes conversion into a corporation and sets forth the substantive requirements and procedures, which are similar to those for a conversion *from* a corporation into another business entity—e.g., approval of a plan of conversion (¶ 8:533) providing for equal treatment of all interests of the same class, conversion of nonredeemable interests only into nonredeemable stock, etc. [See Corps.C. §§ 15911.01 et seq. (limited partnerships), 16902 et seq. (general partnerships), 17710.01 et seq. (limited liability companies)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b. [8:533] **Approval of plan of conversion:** The entity desiring to convert into a corporation must adopt a plan of conversion (or other instrument required to effect the conversion pursuant to the laws under which it is organized). The plan must be approved by the number or percentage of the partners, members or other holders of interest of the converting entity that is required by the laws under which that entity is organized, or a greater or lesser percentage as may be set forth in the converting entity's partnership agreement, articles of organization, operating agreement or other governing document in accordance with applicable law. [Corps.C. § 1157(b), (c); see also Corps.C. § 3307(b), (c) (SPCs)]

(1) [8:533.1] **Conversion into benefit corporation:** Where a noncorporate entity converts into a benefit corporation, the conversion must be approved by the "minimum status vote" (ordinarily, two-thirds of every class or series of interest entitled to receive a distribution of any kind from the entity regardless of any otherwise applicable limitation on the voting rights of the interest). [Corps.C. § 14603(d); see Corps.C. § 14601(d)(2), ¶ *9:538 ff.*]

c. [8:534] **Filing of statement of conversion; effective date:** The converting entity must file with the Secretary of State *articles of incorporation*, which must contain a *statement of conversion* setting forth the converting entity's (1) name, form and jurisdiction, and (2) file number (if any) in the Secretary of State's office. The conversion is effective upon the Secretary of State's filing of the articles unless the articles set forth a delayed effective date pursuant to Corps.C. § 110(c). [Corps.C. § 1157(d) & (e)(1), (2); see also Corps.C. § 3307(d) & (e)(1), (2)(SPCs)]

(1) [8:535] **Additional requirements for foreign entities:** The statement of conversion of a *foreign* converting entity must also set forth a statement that:

• The converting entity is authorized to effect the conversion by the laws under which it is organized;

• The entity has approved a plan of conversion or other instrument as required by the laws under which it is organized; and

• The conversion has been approved by the number or percentage of the entity's partners, members or other holders of interest that is required by the laws under which it is organized (or such greater or lesser percentage as may be set forth in its partnership agreement, articles of organization, operating agreement or other governing document in accordance with applicable laws). [Corps.C. § 1157(e)(3); see also Corps.C. § 3307(e)(3) (SPCs)]

d. [8:536] **Effect of conversion on entity:** The effect of a conversion *into* a corporation is the same as a conversion *from* a corporation into another entity: The corporation is for all purposes—*except franchise and personal income taxation*—the *same entity* that existed before the conversion. [Corps.C. § 1158(a), (b); *see* ¶ *8:490*]

(1) [8:537] **Effect on former partner's liabilities:** An additional protection is given to creditors entering into transactions with a corporation that recently converted from a *partnership:*

If a party to a transaction with a converted corporation reasonably believes when entering into the transaction that a former general partner (now shareholder) continues to be a general partner of the converting partnership after the conversion is effective, such shareholder will be liable for obligations incurred by the converted corporation *within 90 days after the conversion takes effect*. (The shareholder's liability for all other obligations of the converted corporation incurred after the conversion takes effect is that of a *shareholder* of a corporation.) [Corps.C. § 1158(e)]

➪ [8:537.1] ***PRACTICE POINTER:*** A shareholder can avoid this potential problem by giving notice of the conversion to the partnership's creditors. [Corps.C. § 1158(f); *see* ¶ *8:501*]

e. [8:538] **Tax consequences—potential nonrecognition of taxable gain (or loss):** The conversion of a partnership or limited liability company into a corporation is treated for tax purposes as an incorporation/liquidation: The partnership or limited liability company is deemed to contribute all of its assets and liabilities to the corporation in exchange for stock in the corporation, followed immediately by a liquidation of the partnership or limited liability company and distribution of the corporate stock to its partners or members. [Rev.Rul. 2004-59, 2004-1 CB 1050]

Unless the incorporation qualifies for tax-free treatment under IRC § 351 (*see* ¶ *2:160 ff.*), the partnership or limited liability company recognizes taxable gain (or loss) on the property transferred to the corporation; that gain or loss is then passed through to the partners or members (see IRC § 731).

(1) [8:538.1] **S corporation election to avoid intervening C corporation:** A calendar-year partnership that converts into a calendar-year corporation by March 15 may elect to be treated as an S corporation for the entire taxable year in which the conversion occurs. Where the conversion is made effective as of January 1 (*see* ¶ *8:534*), the conversion itself —and its attendant tax consequences (¶ 8:538)—are deemed to occur on the immediately preceding December 31 for tax

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

purposes. This avoids any potential "earnings and profits" and "built-in gains" issues posed by an intervening C corporation. [Rev.Rul. 2009-15, 2009-21 IRB 1035; *see* ¶ *4:484 ff.* re requirements for S corporation election]

(a) [8:538.2] **Comment:** The partnership can be treated as an S corporation for tax purposes simply by making an election under the "check-the-box" regulations (Treas.Reg. § 301.7701-3(a)). However, the partnership would *not* have the limited liability enjoyed by corporations. [See Rev.Rul. 2009-15, supra]

f. [8:539] **Securities law considerations:** Like a conversion *from* a corporation into a noncorporate entity, a conversion from a noncorporate entity *into* a corporation is treated as a *merger* for securities law purposes.

(1) [8:539.1] **Federal law:** *See discussion at ¶ 8:226 ff.*

(2) [8:539.2] **California law:** *See discussion at ¶ 8:511 ff.*

g. [8:540] **Personal liability for unlawful conversion:** A member may be personally liable for tortiously converting an LLC to a corporation. [*Holistic Supplements, L.L.C. v. Stark* (2021) 61 CA5th 530, 544-545, 275 CR3d 791, 799-801—defendant may be personally liable for secretly converting LLC to corporation after transferring ownership of LLC to plaintiff]

[8:541 - 8:580] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 8-D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

D. Sale of Assets

- 1. Procedural Considerations
  - a. [8:584] Board approval required
    - (1) [8:585] "All or substantially all" assets
      - (a) [8:586] Comment
      - (b) [8:587] Compare—IRS guidelines
    - (2) [8:588] Terms
  - b. [8:589] Shareholder approval also required
    - (1) [8:590] 90% approval required if purchaser and seller under common control
      - (a) Exceptions
        - 1) [8:591] Seller given equity in purchaser
          - a) [8:591.1] Added condition re SPCs
        - 2) [8:592] Sale approved by Commissioner
    - (2) [8:593] Compare—sales "in ordinary course of business"
      - (a) [8:594] Example—real estate development
      - (b) Other applications
    - (3) [8:598] Compare—encumbrances on corporate assets
      - (a) [8:599] Comment
    - (4) [8:601] Compare—options on corporate assets
    - (5) Compare—sale of SPC assets
      - (a) [8:601.1] Two-thirds shareholder approval required
      - (b) [8:601.2] No exception for sale in ordinary course of business
    - (6) Compare—sale of benefit corporation assets
      - (a) [8:601.3] Two-thirds shareholder approval required
      - (b) [8:601.4] Dissenters' rights available
    - (7) [8:602] Effect of failure to obtain shareholder approval
      - (a) [8:603] Only shareholders can object
        - 1) [8:604] Compare—non-shareholder cannot object
      - (b) [8:605] Relief available
      - (c) [8:606] Shareholder must act diligently
  - c. [8:607] Sale of assets proposed by insider
    - (1) [8:608] Who is an "interested party"
      - (a) [8:608.1] Exception—sale not requiring shareholder approval
      - (b) [8:609] Exception—corporations with less than 100 shareholders

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(c) [8:610] Exception—exchange qualified by permit
(2) [8:611] Independent fairness opinion
(3) [8:612] Competing offers
d. [8:631] Implementing the sale or transfer
(1) [8:632] Establishing corporate authority to act
(a) [8:633] Effect of secretary's certificate
(b) [8:634] Comment
(2) [8:635] Consent of third parties to transfer
(3) [8:637] Assumption of liabilities
(a) [8:638] Coverage by predecessor's insurance
(4) [8:639] Compare—liabilities imposed by law
(a) [8:640] Bulk sales statute
(b) [8:641] Sales taxes
(c) [8:643] Unemployment insurance contributions
(d) [8:644] Federal withholding taxes
(e) [8:645] Federal labor law violations
1) [8:646] Factors considered
2) [8:647] Compare—ERISA violations
a) [8:647.1] Constructive notice as basis for liability
(f) [8:648] CERCLA claims
(g) [8:656] Purchaser as "mere continuation" of seller ("sham sale")
1) [8:657] Not limited to purchase of *corporate* assets
2) [8:658] Seller added as judgment debtor
(h) [8:663] Product liability claims
1) [8:664] Also applies to distributors and retailers
2) [8:665] Successor not necessarily covered by predecessor's insurance
a) [8:666] Compare—coverage for claims arising before acquisition
b) [8:668] Distinguish—de facto merger
3) Limitations on implied successor liability
a) [8:669] Confined to strict liability theory of recovery
b) [8:670] Causal connection with dissolution
1/ [8:671] Effect of bankruptcy
2/ [8:672] Several intervening purchasers
3/ [8:673] Predecessor continued to exist
c) [8:681] No successor liability for partial acquisitions
d) [8:682] No successor liability for stock acquisitions
1/ [8:683] Distinguish—stock purchase followed by merger
e) [8:684] No implied liability against successor who cannot perform risk-spreading role
(5) [8:691] Security for unpaid purchase price
(6) [8:692] Special employee notice requirements (layoffs, plant closures, relocations)
(7) [8:693] Sale does not transfer attorney-client privilege
2. [8:701] Tax Considerations
a. [8:703] Compare—state sales tax
3. [8:711] Securities Law Considerations
a. Federal securities laws
(1) [8:712] Proxy rules
(2) [8:713] Registration and exemptions
b. [8:715] California Corporate Securities Law

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [8:716] Negotiations exempt
(2) [8:717] Issuance
(3) [8:718] Possible exemptions
(4) [8:720] Possible preemption
(5) [8:721] Soliciting shareholder approvals
(6) [8:722] Qualification procedure

[8:581] As previously discussed, certain sales of corporate assets are treated as reorganizations: A sale of all or "substantially all" of a corporation's assets in exchange in whole or in part for *stock* or inadequately-secured, long-term (more than five years) *debt* securities of the purchaser corporation, is treated as a "sale-of-assets reorganization" and thus subject to board and shareholder approval requirements. [Corps.C. § 181(c); see also Corps.C. § 2511(c) (SPCs); *and* ¶ *8:259*]

But a sale for cash, short-term (less than five-year) debt, or other property—without *any* equity securities or longer-term unsecured debt of the purchaser in the exchange—*is not a reorganization*.

Such a sale is subject to different statutory requirements (Corps.C. §§ 1000-1002, 3100 (SPCs), 14604(d) (benefit corporations); *see* ¶ *8:584 ff.*). The most significant difference is that, except in the case of benefit corporations (*see* ¶ *9:652*), there are no statutory appraisal rights; i.e., although shareholder approval is generally required (¶ 8:589), *dissenters have no right to be "cashed out,"* as they do in a "sale-of-assets reorganization." There are also significant tax differences, described at ¶ *8:701*.

[8:582 - 8:583] ***Reserved.***

1. Procedural Considerations

a. [8:584] **Board approval required:** A corporation may not sell, lease, convey, exchange, transfer or otherwise dispose of "all or substantially all" of its assets unless the board of directors has approved the "principal terms" of the transaction. [Corps.C. § 1001(a); see also Corps.C. § 3100(a) (SPCs)]

(1) [8:585] **"All or substantially all" assets:** Under the Code, board (and shareholder) approval is required only as to transfers involving "all or substantially all" the corporate assets, and lesser amounts can be sold in the ordinary course of business by authorized officers or employees without the need for specific board (or shareholder) approval. (However, as a practical matter, board approval will—and always should—be sought for any substantial asset sale.) [See Corps.C. § 1001(a); see also Corps.C. §§ 3100(a) (SPCs), 14604(d) (benefit corporations)]

(a) [8:586] **Comment:** Unfortunately, nothing in the statute or cases sheds any light on what amount or percentage of corporate assets constitutes "substantially all" of the total. Arguably, only transfers that would render the corporation *unable to continue* in business in its usual way should be subject to the requirement of specific approval by the board of directors and shareholders.

(b) [8:587] **Compare—IRS guidelines:** The IRS has provided an advance ruling guideline as to what constitutes "substantially all" of a corporation's assets for purposes of a tax-free "C reorganization" (*discussed at* ¶ *8:276*). It requires transfer of at least 90% in value of the selling corporation's net assets, and at least 70% in value of its gross (total) assets. [Rev.Proc. 77-37, 1977-2 CB 568; *see* ¶ *8:278*]

However, this guideline was promulgated for *tax* purposes, and it is doubtful that state courts would adopt such a mathematical approach to determine whether board and shareholder approval is required under the Corporations Code provisions (¶ 8:585).

(2) [8:588] **Terms:** The terms and conditions of any such transfer of corporate assets is generally within the discretion of the board. The sale may be for whatever consideration the board deems in the "best interest" of the corporation, payable in money or any form of property, including securities of another corporation. [Corps.C. § 1001(c); see also Corps.C. § 3100(c) (SPCs)]

b. [8:589] **Shareholder approval also required:** Unless the sale or transfer of substantially all the corporate assets is in the "usual and regular course" of its business, the transaction must also be approved by a majority of the shares entitled to vote

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(or any greater percentage required by the articles). Such shareholder approval may either precede or follow board approval. [Corps.C. § 1001(a); compare *¶ 9:302 ff.* re SPCs, *¶ 9:651* re benefit corporations]

(1) [8:590] **90% approval required if purchaser and seller under common control:** Where the seller corporation is controlled by the purchaser, or they are commonly controlled (i.e., not an “arm's length” transaction), there is an obvious risk of a “rigged” price. Therefore, the Code requires that the principal terms be approved by at least *90%* of the voting shares of the seller corporation. (This gives the minority shareholders some protection against the purchaser taking the seller's assets at “bargain” prices or on unfair terms.) [Corps.C. § 1001(d); see also Corps.C. § 3100(d) (SPCs); and *Busse v. United Panam Fin'l Corp.* (2014) 222 CA4th 1028, 1034, 166 CR3d 520, 524—shareholder who owned approximately 40% of stock of corporation that was being acquired in merger (and who also controlled acquiring corporation) had effective control of acquired corporation absent other major shareholders (decided under Corps.C. § 1312(b), which refers to direct *or indirect* control; *see ¶ 8:365*)]

(a) Exceptions

1) [8:591] **Seller given equity in purchaser:** The 90%-approval requirement does not apply if the assets are sold solely for the purchaser's or its parent's nonredeemable common stock (or nonredeemable equity securities where the issuer is a noncorporate entity). Reason: In this event, the seller corporation continues to have an ownership interest in the assets. Further, the transaction is deemed a “sale-of-assets *reorganization*,” and the minority shareholders are protected by statutory *appraisal rights*. [Corps.C. §§ 1001(d), 1300(a); see Corps.C. § 181(c); see also Corps.C. § 2511(c) (SPCs)]

a) [8:591.1] **Added condition re SPCs:** Where the seller is an SPC, this exception to the 90%-approval requirement applies only if the purchaser, in addition to paying for the assets with its own or its parent's nonredeemable equity securities, is an SPC (or other business entity) whose articles (or other organizational document) specify *materially the same purposes*. [Corps.C. § 3100(d); *see ¶ 9:303 ff.*]

2) [8:592] **Sale approved by Commissioner:** The 90%-approval requirement does not apply if the Financial Protection and Innovation Commissioner, after a hearing, approves the terms, conditions and “fairness” of the transaction. (For corporations subject to the jurisdiction of the Insurance Commissioner or the Public Utilities Commission, the 90%-approval requirement likewise does not apply if the relevant agency has approved the terms, conditions and “fairness” of the transaction.) [Corps.C. § 1001(e); see also Corps.C. § 3100(e) (SPCs)]

(2) [8:593] **Compare—sales “in ordinary course of business”:** A sale of substantially all the corporation's assets can be authorized by the board alone, *without* any shareholder approval, if such sale “is in the usual and regular course of its business”—i.e., if the sale carries out the business purpose for which the corporation was formed, and in which it has regularly been engaged. [Corps.C. § 1001(a); see also Corps.C. § 14604(d) (benefit corporations); compare *¶ 8:601.2* re SPCs]

(a) [8:594] **Example—real estate development:** A corporation organized to buy, develop and sell certain real estate can sell such property by authority of the board alone, without shareholder approval. [See *Jeppi v. Brockman Holding Co., Inc.* (1949) 34 C2d 11, 15-16, 206 P2d 847, 849-850; see also *Keck Enterprises, Inc. v. Braunschweiger* (SD CA 1952) 108 F.Supp. 925, 928; and *Owens v. Palos Verdes Monaco* (1983) 142 CA3d 855, 865-866, 191 CR 381, 387-388 (disapproved on other grounds by *Applied Equip. Corp. v. Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 521, 28 CR2d 475, 485, fn. 10)—partner of partnership in business of investing in unimproved real property acts within usual course of business when selling partnership real property 18 years after it was acquired (consent of all partners not required)]

➪ [8:595] ***PRACTICE POINTER:*** Even so, as a practical matter, the seller corporation may be compelled to obtain approval of its shareholders. This is because the purchaser (or lender financing the purchase) is often unwilling to gamble on whether approval by the seller's shareholders is legally required, and will insist upon it as a condition of the transaction. (In addition, prudence may preclude corporate counsel from giving a legal opinion that such approval is not required.)

In order to satisfy such purchaser or lender, the seller corporation can furnish a *certificate* by the secretary or assistant secretary of the corporation as to the board and shareholder action; see Corps.C. § 1002, *discussed at ¶ 8:632*.

(b) Other applications

• [8:596] **Productive assets:** A sale of machinery, equipment or other productive assets needed in the business operation would ordinarily *not* be "in the usual and regular course of business."

But, the result may be otherwise if the sale is simply an exchange of assets (e.g., sale proceeds used to purchase other, similar operating assets); or if the machinery and equipment were acquired or produced for the purpose of sale (i.e., as inventory). In such cases, the sale of such assets should not require approval by the seller's shareholders.

• [8:597] **Change of business:** Shareholder approval should be required if a corporation sells its assets in order to start a new and different business. Even though the corporation intends to remain in business, such a sale can hardly be said to be "in the usual and regular course" of its original business.

(3) [8:598] **Compare—encumbrances on corporate assets:** The Code expressly provides that the board alone may authorize a mortgage, deed of trust, pledge or other lien on the corporation's real or personal property, for the purpose of securing any corporate contract or obligation. Unless the articles provide otherwise, shareholder approval is not required. [Corps.C. § 1000]

(a) [8:599] **Comment:** Note the effect of this provision: Shareholders have no right to veto improvidently secured borrowings by the corporation, even though a default would jeopardize the corporate assets—i.e., while shareholders can prevent loss of all corporate assets through improvident *sales*, they cannot prevent loss thereof through improvident loans.

➪ [8:600] ***PRACTICE POINTER:*** In view of this risk, you may wish to recommend, for closely-held corporations that do not intend to incur secured debt in the ordinary course (e.g., a company that will provide services), that the articles be drafted to require shareholder approval for encumbrances on corporate assets. Where corporate borrowings are frequent or routine, it may be appropriate to require shareholder approval only for secured debt in excess of a certain amount.

(4) [8:601] **Compare—options on corporate assets:** Options to purchase substantially all the corporate assets can be granted by the board alone without shareholder approval. However, shareholder approval would be required prior to consummation of the sale upon exercise of the option. (If the shareholders veto the sale, the corporation may be liable for breach of the option contract unless the contract conditions the sale upon shareholder approval—which of course it should.) [See *Bradford v. Sunset Land & Water Co.* (1916) 30 CA 87, 89-90, 157 P 20, 21; and *Seeburg v. El Royale Corp.* (1942) 54 CA2d 1, 3, 128 P2d 362, 363]

(5) Compare—sale of SPC assets

(a) [8:601.1] **Two-thirds shareholder approval required:** *See ¶ 9:302*.

(b) [8:601.2] **No exception for sale in ordinary course of business:** Shareholder approval is required of *any* sale of all or substantially all of the assets of an SPC—i.e., there is no exception for a sale in the usual and regular course of business. [Corps.C. § 3100(a); *see ¶ 9:303 ff.*]

(6) Compare—sale of benefit corporation assets

(a) [8:601.3] **Two-thirds shareholder approval required:** *See ¶ 9:651*.

(b) [8:601.4] **Dissenters' rights available:** *See ¶ 9:652*.

(7) [8:602] **Effect of failure to obtain shareholder approval:** Although the language of the statute appears to be mandatory, case law holds that failure to obtain shareholder approval, where required, does not by itself void the transaction. Rather, its effect depends on who attacks the transfer and what relief is sought.

(a) [8:603] **Only shareholders can object:** The only persons permitted to attack a transfer of corporate assets for lack of shareholder approval are *shareholders* of the seller corporation. [See *Bickston v. Federal Firearms Corp. of Calif.* (1964) 227 CA2d 574, 580, 38 CR 793, 796—shareholder who was also a creditor of corporation could challenge sale of corporation's assets to other shareholders]

1) [8:604] **Compare—non-shareholder cannot object:** Others claiming an interest in the corporate assets or in the transfer lack standing to attack a sale on the ground that it had not been approved by the shareholders. This includes:

• The *transferee*; [*Gunther v. Thompson* (1931) 211 C 631, 634, 296 P 611, 612]

• The *corporation* (seller), either directly or in a shareholder's derivative suit; [*Associates Discount Corp. v. Tobb Co., Inc.* (1966) 241 CA2d 541, 549, 50 CR 738, 743 (superseded by statute on other grounds as recognized by *Snukal v. Flightways Mfg., Inc.* (2000) 23 C4th 754, 781-782, 98 CR2d 1, 24)]

• A judgment *creditor* of the corporation; [*Long Const. Co. v. Empire Drive-In Theatres, Inc.* (1962) 208 CA2d 726, 735-736, 25 CR 509, 514]

• A third party seeking to forfeit the title conveyed (a stranger to the transaction). [*Galbraith v. Shasta Iron Co.* (1904) 143 C 94, 99, 76 P 901, 903]

(b) [8:605] **Relief available:** A shareholder can apparently sue to *enjoin* a sale for lack of shareholder approval, if suit is filed *before* the sale is consummated.

But once the sale is complete and title conveyed, it may be difficult to obtain effective relief: Rescission or other equitable relief *cannot* be granted against an innocent purchaser for value.

(c) [8:606] **Shareholder must act diligently:** Even if shareholders have standing to attack the transaction, they must act diligently if they seek equitable relief. Otherwise, they may find their suit barred by the equitable doctrine of laches (unreasonable delay causing prejudice to opposing party). [*King v. Los Angeles County Fair Ass'n* (1945) 70 CA2d 592, 596-597, 161 P2d 468, 470-471; *Alhambra-Shumway Mines, Inc. v. Alhambra Gold Mine Corp.* (1962) 200 CA2d 322, 326, 19 CR 208, 210]

c. [8:607] **Sale of assets proposed by insider:** Where the sale of assets is proposed to *"some or all" of the shareholders* by an *insider* (an "interested party"), special requirements are imposed to ensure that the shareholders will be treated fairly in the non-arm's-length transaction. [Corps.C. § 1203(a) (emphasis added)]

(1) [8:608] **Who is an "interested party":** The special requirements apply to sale-of-assets proposals made to a corporation by anyone who:

• Directly or indirectly *controls* the corporation;

• Is directly or indirectly controlled by any of the corporation's officers or directors; or

• Is an entity in which any of the corporation's directors or "executive officers" (i.e., president, vice-president, or other persons serving similar policy-making functions) holds a *material financial interest*. [Corps.C. § 1203(a)]

(a) [8:608.1] **Exception—sale not requiring shareholder approval:** The special requirements do not apply to a sale of assets not requiring shareholder approval—i.e., a sale in the ordinary course of business. [Corps.C. § 1203(a); see Corps.C. § 1001(a)]

(b) [8:609] **Exception—corporations with less than 100 shareholders:** Nor do the special requirements apply where the proposal is made to a corporation with *less than 100* shareholders of record. [Corps.C. § 1203(a)]

(c) [8:610] **Exception—exchange qualified by permit:** The special requirements do not apply to a transaction that has been qualified by permit from the Financial Protection and Innovation Commissioner. [Corps.C. § 1203(a)]

(Note: To the extent a sale-of-assets transaction does not involve issuance of any securities (*see* ¶ *8:711*), it is not subject to qualification by the Commissioner.)

(2) [8:611] **Independent fairness opinion:** The interested party proposing the sale-of-assets transaction must provide the shareholders with an independent written opinion as to the fairness of the consideration they will receive in the transaction. [Corps.C. § 1203(a)]

(a) **Opining person's qualifications:** *See* ¶ *8:172.10*.

(b) **Delivery of opinion:** *See* ¶ *8:172.11*.

(3) [8:612] **Competing offers:** The board of directors must notify the shareholders of any competing offer requiring shareholder acceptance or approval made at least 10 days before the interested party proposal is to be approved, whether a tender offer, a merger offer, a stock-for-stock exchange (¶ *8:235 ff.*), a sale-of-assets reorganization (¶ *8:259 ff.*) or a

straight sale of assets (¶ *8:581 ff.*). The directors must also forward to the shareholders any written materials provided by the later offeror (at such offeror's expense). [Corps.C. § 1203(b)(1)]

(a) **Insider proposal delayed pending shareholder action on competing offer:** *See* ¶ *8:172.13*.

(b) **Improving insider offer:** *See* ¶ *8:172.14*.

➪ [8:613] ***PRACTICE POINTER:*** When submitting an insider proposal to the shareholders for approval, the corporation should disclose that competing offers received at least 10 days before the proposal is approved will be submitted for shareholder consideration.

[8:614 - 8:630] ***Reserved.***

d. [8:631] **Implementing the sale or transfer:** Assuming requisite board and/or shareholder approvals have been obtained, appropriate instruments of conveyance must be prepared and executed; e.g., deeds as to real property, bills of sale as to personal property, assignments of leases, intangibles, etc.

(1) [8:632] **Establishing corporate authority to act:** The Code provides a procedure to facilitate proof of the requisite board and/or shareholder approvals: A certificate executed by the corporate secretary (or an assistant) may be attached to the deed or instrument of conveyance, stating:

- That the transfer has been approved by the board of directors; and

- *Either* that it has been approved by the outstanding shares, *or* that such approval is not required because less than "substantially all" of the corporation's assets are being conveyed, *or* because the sale thereof is in the "usual and regular course of business," *or* because of the Code provisions dealing with reorganizations. [Corps.C. § 1002]

(a) [8:633] **Effect of secretary's certificate:** The secretary's certificate is "prima facie evidence of the existence of the facts authorizing such conveyance or other transfer of the assets and *conclusive evidence* in favor of any *innocent purchaser* or encumbrancer for value." [Corps.C. § 1002 (emphasis added)]

(b) [8:634] **Comment:** This greatly facilitates sale of corporate assets to innocent purchasers. They need not worry about getting involved in litigation as to whether the corporation's deed or conveyance was validly authorized by its board of directors and shareholders.

(2) [8:635] **Consent of third parties to transfer:** Often, corporate leases can be assigned only with approval of the lessor. Other assets may be subject to liens also requiring consent of the lienholder to sale or transfer; or providing simply that such sale or transfer accelerates the debt secured by such lien (e.g., typical "due on sale" clause).

➪ [8:636] ***PRACTICE POINTER:*** The effect of such consent or acceleration clauses must be analyzed by the seller and purchaser in each case. Such provisions should be disclosed in the agreement of sale or in a disclosure schedule to the agreement, and obtaining the requisite consent should be made a condition of the sale. Be careful not to overlook the necessity for obtaining such consent in sales between related entities.

(3) [8:637] **Assumption of liabilities:** Another potential problem in sales of all or substantially all corporate assets is whether the purchaser has assumed the corporation's liabilities. Obviously, if there are recorded or perfected liens against such assets, the purchaser takes subject to whatever debts or claims are secured thereby. Otherwise, a purchaser is generally not liable for the seller's debts in the absence of agreement (i.e., assumption of the liability). The matter should be covered clearly in the sales agreement.

(a) [8:638] **Coverage by predecessor's insurance:** Ordinarily, a contractual assumption of assets and liabilities does not entitle the purchaser to the benefit of any liability insurance covering the seller where the policy expressly *forbids assignment* without the insurer's consent. However, California law is now settled that the purchaser is entitled to the benefits of the seller's policy for losses covered under the policy and triggered during the policy period *prior to the sale*. This is so notwithstanding any provision in an indemnity insurance policy requiring the insurer's consent to assignment of the policy. Here, liability is imposed by law because the sale did not affect the risk assumed by the insurer and for which the seller paid premiums. [See Ins.C. § 520; *Fluor Corp. v. Sup.Ct. (Hartford Accident & Indemnity Co.)* (2015) 61 C4th 1175, 1218-1224, 191 CR3d 498, 531-536 (overruling *Henkel Corp. v. Hartford Accident & Indemnity Co.* (2003) 29 C4th 934, 129 CR2d 828)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(4) [8:639] **Compare—liabilities imposed by law:** There are a number of obligations of the seller for which the purchaser may be held liable, even if *not* assumed in the sale agreement. Of particular importance are the following:

(a) [8:640] **Bulk sales statute:** If the seller's business is subject to the bulk sales law, notice to the seller's creditors must be recorded and published before the sale date. Otherwise, the buyer is liable to the seller's creditors for damages in the amount of the creditors' claims (less any "unrecoverable" amounts). [Comm'l C. §§ 6105, 6107; *see ¶ 4:511 ff.*]

(b) [8:641] **Sales taxes:** A purchaser of a business is liable, up to the amount paid, for any unpaid sales taxes owing to the State of California arising out of operation of the business prior to the sale. [Rev. & Tax.C. §§ 6811, 6812; see *Schnyder v. State Bd. of Equalization* (2002) 101 CA4th 538, 545-550, 124 CR2d 571, 575-579—compliance with bulk sales statute (¶ *8:640*) does not avoid buyer's liability for seller's unpaid sales taxes]

➪ [8:642] ***PRACTICE POINTER:*** If time permits before the sale closes, you can obtain from the State Board of Equalization a notice stating the amount of taxes due (or a receipt showing all taxes have been paid or a certificate stating no amount is due). The purchaser can then withhold enough of the price to cover this liability. If such notice cannot be obtained in time, the parties will have to estimate the amount due. [See *Schnyder v. State Bd. of Equalization* (2002) 101 CA4th 538, 545-546, 124 CR2d 571, 575-576]

(c) [8:643] **Unemployment insurance contributions:** Likewise, the purchaser of a business is liable for unpaid contributions to the State Unemployment Fund (including interest and any penalties thereon) due from the seller prior to the sale. [See Unemp.Ins.C. § 1731]

➪ [8:643.1] **PRACTICE POINTER:** The purchaser should require the seller to obtain a Certificate of Release of Buyer (DE 2220) from the Department of Employment Development showing in essence that all contributions owing to the State Unemployment Fund up to the date of sale have been paid. Information on obtaining such a certificate is contained in the Department's publication, Requirements for Obtaining Certificate of Release of Buyer (DE 2220) When a Business Is Sold (DE 3409A), available on the Department's website (*www.edd.ca.gov*).

(d) [8:644] **Federal withholding taxes:** The purchaser of a business who retains the seller's employees is liable for any unpaid federal income and social security taxes due by the seller during the calendar year. [IRC § 3121(a)(1)]

(e) [8:645] **Federal labor law violations:** Federal courts have developed a common law successor liability doctrine that extends to almost every federal employment law statute, including the National Labor Relations Act, the Fair Labor Standards Act, the Age Discrimination in Employment Act, Title VII claims and ERISA. [See *Steinbach v. Hubbard* (9th Cir. 1995) 51 F3d 843, 845]

1) [8:646] **Factors considered:** Successor liability under federal labor laws can attach when:

• The purchaser is a *bona fide successor* (i.e., there is *business continuity* between the seller and purchaser);

• The purchaser had *notice* of the potential liability;

• The predecessor is *unable to provide adequate relief directly*; *and*

• Considerations of *equity and fairness* favor imposing liability on the purchaser. [*Steinbach v. Hubbard* (9th Cir. 1995) 51 F3d 843, 846-847—potential purchaser who merely leased predecessor's assets at $600/mo. for 4 months not liable for $100,000 in unpaid wages claimed under Fair Labor Standards Act (29 USC § 201 et seq.)]

2) [8:647] **Compare—ERISA violations:** In purchasing the operating assets of a company that is going out of business, the purchaser may be deemed a "successor" to the dissolving company with respect to its "withdrawal liability" to a multi-employer union pension plan. (A "withdrawal liability" is a withdrawing employer's share of a shortfall in funds necessary to meet the plan's anticipated pension obligations.) Even if the purchaser acquires only some of the seller's assets and hires only some of the seller's employees, the purchaser may be liable for the seller's "withdrawal liability" so long as the successor takes over a *substantial portion* of the seller's business and has *actual or constructive notice* (*see ¶ 8:647.1*) of the pension withdrawal liability. [See *Heavenly Hana LLC v. Hotel Union & Hotel Industry of Hawaii Pension Plan* (9th Cir. 2018) 891 F3d 839, 845-847; *Resilient Floor Covering Pension Trust Fund Bd. of Trustees v. Michael's Floor Covering, Inc.* (9th Cir. 2015) 801 F3d 1079, 1095-1099]

a) [8:647.1] **Constructive notice as basis for liability:** Constructive notice exists when a purchaser *using reasonable care or diligence would have discovered the seller's "withdrawal liability*." But even where constructive

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

notice is present, liability will be imposed only when it is fair to do so. [*Heavenly Hana LLC v. Hotel Union & Hotel Industry of Hawaii Pension Plan* (9th Cir. 2018) 891 F3d 839, 847]

• [8:647.2] A hotel purchaser had constructive notice of the seller's "withdrawal liability" (¶ 8:647) and was liable therefor where (i) the purchaser had previously operated a hotel that participated in a multiemployer pension plan, (ii) the purchaser had made prior acquisitions involving multiemployer pension plans in which it required its agents to check for potential "withdrawal liability," (iii) the purchase agreement plainly disclosed the hotel employees' participation in a multiemployer pension plan, and (iv) the pension plan's annual funding notices indicating underfunding were posted on the Internet. [*Heavenly Hana LLC v. Hotel Union & Hotel Industry of Hawaii Pension Plan* (9th Cir. 2018) 891 F3d 839, 847]

(f) [8:648] **CERCLA claims:** *See ¶ 6:597.5*.

[8:649 - 8:655] ***Reserved.***

(g) [8:656] **Purchaser as "mere continuation" of seller ("sham sale"):** Where the purchaser corporation acquires the seller's assets (but not the liabilities) for inadequate consideration, has practically the same shareholders and management as the seller, and carries on the same business, the purchaser may be regarded as a "mere continuation" of the seller. In such circumstances, the purchaser corporation is essentially the *same entity* as the seller, and may be held liable for the seller's obligations. This is especially so "when actual fraud or the rights of creditors are involved"—i.e., little or no cash is paid for the seller's assets and the object of the transaction appears to be avoidance of specific debts or liabilities. [See *Wolf Metals Inc. v. Rand Pac. Sales, Inc.* (2016) 4 CA5th 698, 704-705, 709, 209 CR3d 198, 203-204, 207 (referred to as "successor corporation" doctrine); *Hernandez v. Enterprise Rent-A-Car Co. of San Francisco* (2019) 37 CA5th 187, 196-197, 249 CR3d 467, 474-475; *CenterPoint Energy, Inc. v. Sup.Ct. (City & County of San Francisco)* (2007) 157 CA4th 1101, 1120-1121, 69 CR3d 202, 218-219; also see *Cleveland v. Johnson* (2012) 209 CA4th 1315, 1326-1335, 147 CR3d 772, 781-788—"mere continuation" doctrine applied where corporation effectively acquired another corporation's division (line of business) by assuming leases and other property in attempt to defraud transferor corporation's investors; *and ¶ 8:275.1*]

1) [8:657] **Not limited to purchase of** ***corporate assets:*** The "mere continuation" doctrine is not confined to the situation where a corporation purchases the asset of another corporation. A corporation may be deemed the "mere continuation" of a noncorporate entity (e.g., partnership) that sells its assets to the corporation. [*Phillips, Spallas & Angstadt, LLP v. Fotouhi* (2011) 197 CA4th 1132, 1139-1140, 128 CR3d 320, 325-326 (corporation acquired assets of limited liability partnership for purpose of avoiding specific liabilities of partnership and its principal partner)]

2) [8:658] **Seller added as judgment debtor:** A creditor who obtained a judgment against the seller may, but need not, file an independent action against the buyer. Instead, the creditor may, upon motion, amend the judgment to add the buyer as a judgment debtor. [*Wolf Metals Inc. v. Rand Pac. Sales, Inc.* (2016) 4 CA5th 698, 709-711, 209 CR3d 198, 207-208; *McClellan v. Northridge Park Townhome Owners Ass'n, Inc.* (2001) 89 CA4th 746, 752-753, 107 CR2d 702, 705-706; see *Phillips, Spallas & Angstadt, LLP v. Fotouhi* (2011) 197 CA4th 1132, 1139-1142, 128 CR3d 320, 325-328—charging order against partner's interest in limited liability partnership (per CCP § 708.310 and Corps.C. § 16504(a)) applied against his shareholder interest in corporation that was "mere continuation" of partnership; *see also ¶ 2:57.4*]

[8:659 - 8:662] ***Reserved.***

(h) [8:663] **Product liability claims:** Generally, the purchaser of the assets and goodwill of a manufacturing corporation in an *arm's length transaction* is not liable for product liability claims against the seller-manufacturer. However, where the purchase leads to the seller's *dissolution and liquidation*, the purchaser may be held to *impliedly assume liability* for *personal injuries* caused by products previously manufactured—even if the claim arose after the sale.

A three-prong test applies—i.e., such "successor liability" will be imposed on the purchaser if:

• It has the ability to assume the original manufacturer's risk-spreading role;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- It continues to market the same product under the same name (thereby exploiting the goodwill derived from the seller); and

- The asset purchase contributed to the seller's liquidation, leaving the victims with no effective remedy against the seller (i.e., they would be faced with almost insuperable obstacles in attempting to satisfy a judgment against the former stockholders who had received the assets of the dissolved corporation). [*Ray v. Alad Corp.* (1977) 19 C3d 22, 31-33, 136 CR 574, 580-581; see *Hernandez v. Enterprise Rent-A-Car Co. of San Francisco* (2019) 37 CA5th 187, 192-193, 249 CR3d 467, 471—purchaser of corporate assets not liable where seller subsequently merged with another corporation and thereby gave plaintiff recourse to solvent defendant; *Rosales v. Thermex-Thermatron, Inc.* (1998) 67 CA4th 187, 196, 78 CR2d 861, 866—determination whether to impose successor liability involves broad equitable considerations and hence is for court (not jury) to decide]

1) [8:664] **Also applies to distributors and retailers:** Successor liability is not limited to manufacturers; it may also reach *distributors* or *retailers* of defective products who meet the requirements of *Ray v. Alad*, ¶ 8:663. Reason: "To hold *Ray* inapplicable to successor distributors and retailers would be contrary to the policy of compensating injured plaintiffs from the resources of those better capable of estimating and spreading the risk of the marketing of defective products." [*Kaminski v. Western MacArthur Co.* (1985) 175 CA3d 445, 456, 220 CR 895, 901]

2) [8:665] **Successor not necessarily covered by predecessor's insurance:** Whether the seller's insurance covers liability claims asserted against the successor for injuries arising from the seller's products is determined by the insurance *policy* (specifically, the policy's "assignability" provisions). Though successor liability is imposed by operation of law, the law cannot compel the seller's insurer to extend coverage to the successor corporation, "a stranger to the insurance contract." [*General Accident Ins. Co. of America v. Sup.Ct. (Western MacArthur Co.)* (1997) 55 CA4th 1444, 1454-1455, 64 CR2d 781, 788]

a) [8:666] **Compare—coverage for claims arising before acquisition:** *See ¶ 8:638*.

[8:667] ***Reserved.***

b) [8:668] **Distinguish—de facto merger:** An asset acquisition can amount to a de facto merger. This may occur where the purchaser acquires *all* assets, including *choses in action*, and also assumes *all liabilities* of the seller; the purchaser continues to operate the business and the seller dissolves (*see ¶ 8:275.1*). Unless the insurance policy provides otherwise (e.g., insurer's consent required in event of merger or transfer), it, like any other asset of the seller, automatically inures to the "survivor" by operation of merger law (*see ¶ 8:192*). (And, where the loss arose *before* the de facto merger, the insurer's consent is *not* required … because the merger had no impact upon the insurer's risk and obligations under the policy.) [See *CenterPoint Energy, Inc. v. Sup.Ct. (City & County of San Francisco)* (2007) 157 CA4th 1101, 1121, 69 CR3d 202, 219 (quoting text); *Westoil Terminals Co. v. Harbor Ins. Co.* (1999) 73 CA4th 634, 639-643, 86 CR2d 636, 638-641—ostensible asset acquisition that effectively transformed corporation into limited partnership owned and operated by same individual family members amounted to de facto merger (insurer remained liable for environmental claim)]

3) Limitations on implied successor liability

a) [8:669] **Confined to strict liability theory of recovery:** Such successor liability may be imposed only where *strict liability* for defective products is available as a theory of recovery—i.e., implied successor liability cannot be predicated on negligence. [*Franklin v. USX Corp.* (2001) 87 CA4th 615, 628-629, 105 CR2d 11, 20; *Monarch Bay II v. Professional Service Indus., Inc.* (1999) 75 CA4th 1213, 1217-1218, 89 CR2d 778, 780; *Maloney v. American Pharmaceutical Co.* (1988) 207 CA3d 282, 289-290, 255 CR 1, 4-5]

b) [8:670] **Causal connection with dissolution:** The successor corporation must actually have "played some role in curtailing or destroying the plaintiffs' remedies." [*Kline v. Johns-Manville* (9th Cir. 1984) 745 F2d 1217, 1219-1220; *Hernandez v. Enterprise Rent-A-Car Co. of San Francisco* (2019) 37 CA5th 187, 193, 249 CR3d 467, 471-472; *Chaknova v. Wilbur-Ellis Co.* (1999) 69 CA4th 962, 971-972, 81 CR2d 871, 877 (abrogation on other grounds

recognized by *Weber v. John Crane, Inc.* (2006) 143 CA4th 1433, 1441, 50 CR3d 71, 77-78); *Stewart v. Telex Communications, Inc.* (1991) 1 CA4th 190, 199-200, 1 CR2d 669, 675-676]

1/ [8:671] **Effect of bankruptcy:** Such a causal connection may be found where the successor corporation *induces* the predecessor to file for bankruptcy to avoid future tort liability … but *not* where the successor purchases the predecessor's assets following a *good faith* dissolution in bankruptcy not intended to avoid future tort claims. [*Nelson v. Tiffany Indus., Inc.* (9th Cir. 1985) 778 F2d 533, 537-538; *Hernandez v. Enterprise Rent-A-Car Co. of San Francisco* (2019) 37 CA5th 187, 198-199, 201, 249 CR3d 467, 476, 478 (*discussed at ¶ 8:663*); *Stewart v. Telex Communications, Inc.* (1991) 1 CA4th 190, 199-200, 1 CR2d 669, 675-676]

2/ [8:672] **Several intervening purchasers:** Successor liability will not be imposed on the last of several intervening purchasers who had no causal connection to the original business' liquidation. [*Lundell v. Sidney Machine Tool Co.* (1987) 190 CA3d 1546, 1553, 236 CR 70, 75]

3/ [8:673] **Predecessor continued to exist:** Similarly, successor liability will not be imposed where the predecessor continued as an ongoing corporate entity for some time (here, 15 months) before *voluntarily electing* to dissolve: The successor did *not cause* the predecessor's dissolution. [*Chaknova v. Wilbur-Ellis Co.* (1999) 69 CA4th 962, 971-972, 81 CR2d 871, 877 (abrogation on other grounds recognized by *Weber v. John Crane, Inc.* (2006) 143 CA4th 1433, 1441, 50 CR3d 71, 77-78)]

[8:674 - 8:680] ***Reserved.***

c) [8:681] **No successor liability for partial acquisitions:** As stated (¶ 8:663), successor liability will be implied only where the asset purchase leads to the seller's *dissolution* and *liquidation*. Thus, a corporation that acquires only *part* of a manufacturing corporation's assets will not be subject to implied successor liability if the manufacturer remains in business. [*Henkel Corp. v. Hartford Accident & Indemnity Co.* (2003) 29 C4th 934, 942, 129 CR2d 828, 833 (overruled on other grounds by *Fluor Corp. v. Sup.Ct. (Hartford Accident & Indemnity Co.)* (2015) 61 C4th 1175, 1218-1224, 191 CR3d 498, 531-536)—no successor liability on purchase of only one of seller's two product lines; *Kline v. Johns-Manville* (9th Cir. 1984) 745 F2d 1217, 1219-1220—no successor liability for partial acquisition of assets where seller filed for Chapter 11 but did not liquidate; *Phillips v. Cooper Laboratories* (1989) 215 CA3d 1648, 1660, 264 CR 311, 318—no successor liability where original manufacturer remained viable entity until its dissolution 10 years later]

d) [8:682] **No successor liability for stock acquisitions:** Nor will successor liability be imposed where the acquisition is made by purchasing all of the capital *stock* of the manufacturing corporation—rather than buying its physical assets—even if the acquired corporation is later dissolved. In such a case, the purchaser does not impliedly assume the manufacturer's liability—i.e., the rule of shareholder immunity from corporate debts applies, so long as the assets of the acquired corporation were intact at the time of the acquisition. [*Potlatch Corp. v. Sup.Ct.* (1984) 154 CA3d 1144, 1151, 201 CR 750, 755]

1/ [8:683] **Distinguish—stock purchase followed by merger:** The result is different where all the stock is purchased and the acquired corporation is subsequently *merged* into the purchaser/parent: The parent, as the "surviving corporation," assumes the acquired corporation's liabilities by operation of law (Corps.C. § 1107, *¶ 8:193*). This is so even where the acquired corporation ceased business long before the merger and existed only as a "shell." [*Petrini v. Mohasco Corp.* (1998) 61 CA4th 1091, 1095-1099, 71 CR2d 910, 912-915; see *Hernandez v. Enterprise Rent-A-Car Co. of San Francisco* (2019) 37 CA5th 187, 194, 249 CR3d 467, 472-473]

e) [8:684] **No implied liability against successor who cannot perform risk-spreading role:** Finally, successor liability will not be imposed absent some "equivalence" between the predecessor's and successor's *assets and resources*. The successor cannot fulfill the *Ray* "risk-spreading role" where it is engaged in a different business that is much *smaller* than the predecessor's (*Lundell v. Sidney Machine Tool Co.* (1987) 190 CA3d 1546, 1553, 236 CR 70, 75) or where it is no longer in the business, having sold out years before it became aware of plaintiff's injury (*Chaknova v. Wilbur-Ellis Co.* (1999) 69 CA4th 962, 972, 81 CR2d 871, 877-878 (abrogation on other grounds recognized by *Weber v. John Crane, Inc.* (2006) 143 CA4th 1433, 1441, 50 CR3d 71, 77-78)).

[8:685 - 8:690] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(5) [8:691] **Security for unpaid purchase price:** If the sale price is payable in installments over a period of time, the seller corporation may require security for its payment. Such security may consist either of assets previously owned by the purchaser, or of the purchased assets themselves (or some portion thereof), or even of the purchaser's after-acquired assets. In either event, to be enforceable against others, such security interests have to be perfected or recorded as required by law for real or personal property security interests (Comm'l C. § 9101 et seq.).

(6) [8:692] **Special employee notice requirements (layoffs, plant closures, relocations):** If the asset sale results in a *mass layoff* or a *plant closure or relocation* affecting at least 50 employees, special notice requirements may need to be satisfied pursuant to the federal Worker Adjustment and Retraining Notification Act ("WARN Act," 29 USC §§ 2101-2109) and its California counterpart (Lab.C. § 1400 et seq.). *See discussion at ¶ 8:1041 ff.*

(7) [8:693] **Sale does not transfer attorney-client privilege:** After a sale of assets, the seller corporation continues to exist and thus continues to hold any attorney-client privilege. The sale itself does not transfer the privilege, and thus the purchaser corporation may not assert or waive the privilege that remains with the seller. [*Favila v. Katten Muchin Rosenman LLP* (2010) 188 CA4th 189, 218-219, 115 CR3d 274, 297-298]

[8:694 - 8:700] ***Reserved.***

2. [8:701] **Tax Considerations:** Unless structured as a tax-free "C reorganization" (¶ 8:276), a sale of assets is taxable as any other capital transaction—i.e., gain or loss is recognized by the seller corporation at the time of sale. (Since the exchange is not tax-free, there is no carryover basis: The purchaser gets a new, purchase price basis on the acquired assets.)

➪ [8:702] ***PRACTICE POINTER:*** If you represent a corporation that is selling all or substantially all of its assets, be sure to consider a sale-of-assets reorganization ("C reorganization") as an alternative to an outright sale because of the tax advantages.

Sometimes, however, a seller's desire for cash or short-term notes precludes structuring the transaction as a reorganization; or the purchaser insists on an outright sale (usually in order to get a higher basis in the assets purchased or because it wants to own the assets directly).

In such cases, if you represent the seller, try to draft the sale agreement to *allocate* the purchase price among the various assets (each asset being assigned a portion or percentage of the aggregate sales price). This gives the parties some control over the tax treatment. The seller recognizes gain or loss on each asset accordingly; and the purchaser depreciates each asset accordingly. As long as based on "arm's length" dealings (and absent "mistake, undue influence, fraud or duress"), the parties' written allocations will govern. [IRC § 1060(a); see also Treas.Reg. § 1.1245-1(a)(5); *Particelli v. Commr.* (9th Cir. 1954) 212 F2d 498, 500-502] (However, the allocations *must* meet the requirements of special regulations promulgated under IRC § 338(b)(5).)

a. [8:703] **Compare—state sales tax:** In addition to income tax, the sale may be subject to California *sales tax* if it involves tangible personal property. [See Rev. & Tax.C. § 6001 et seq.]

It makes no difference that the transaction could have been structured so as to avoid sales taxes (e.g., as a merger; ¶ *8:192.1*), if in fact it was not. "It is perhaps an inevitable … consequence of applying revenue measures to sophisticated commercial arrangements that tax consequences sometimes vary according to the *forms* of transactions that nonetheless accomplish substantially the same results." [*Simplicity Pattern Co., Inc. v. State Bd. of Equalization* (1980) 27 C3d 900, 915, 167 CR 366, 375 (emphasis added) (disapproved on other grounds by *Navistar Int'l Transp. Corp. v. State Bd. of Equalization* (1994) 8 C4th 868, 877, 35 CR2d 651, 655, fn. 4)]

[8:704 - 8:710] ***Reserved.***

3. [8:711] **Securities Law Considerations:** A sale of assets involves no securities law considerations, unless the purchaser is paying for the assets by issuing its own securities.

If the purchaser is issuing *stock* or unsecured, long-term (more than five-year) *debt* in full or partial payment for the assets, the transaction may be treated as a "sale-of-assets reorganization," and subject to the requirements discussed at ¶ *8:283*.

If the purchase is for cash, short-term debt, or adequately-secured long term debt, the sale is not a reorganization (¶ *8:581*). But it may still be subject to the following federal and state securities law provisions:

a. Federal securities laws

(1) [8:712] **Proxy rules:** If the transaction requires approval by shareholders of the seller corporation, and if that corporation is subject to the reporting and registration requirements of the 1934 Act, solicitation of shareholder approval is subject to the federal proxy rules. [SEA § 14(a); SEC Reg. 14A]

(2) [8:713] **Registration and exemptions:** If the transaction involves issuance of securities, the registration and exemption provisions of the 1933 Act must be considered.

[8:714] Since the securities would be issued to only one "purchaser" (the corporation selling its assets), the transaction would normally be exempt under the "private offering" exemption (SA § 4(a)(2), ¶ 5:171 ff.). Or, it may be exempt under the intrastate offering exemption (SA § 3(a)(11) and SEC Rules 147 and 147A, ¶ 5:81 ff.).

Alternatively, an exemption could be claimed under Regulation D, but this would require investment intent, and usually result in the securities being "restricted" as to their resale or retransfer (SEC Rule 144; *¶ 5:126 ff.*). Thus, if the seller corporation plans a *distribution* of the purchaser's securities to its own shareholders within one year following their approval of the asset sale (pursuant to a plan of liquidation or otherwise), the Regulation D exemptions may not be relied upon, and the issuance would have to be registered. [See SEC Rule 145(a)(3)(iii), *¶ 8:286*]

b. [8:715] **California Corporate Securities Law:** Where securities are offered for assets of another corporation, the transaction is subject to qualification by permit unless otherwise exempt—i.e., it is subject to the same rules as a "sale of assets reorganization." [Corps.C. § 25120; Commr. Rule 260.140.60-260.140.62; *see ¶ 8:288*]

(1) [8:716] **Negotiations exempt:** An offer or agreement between two corporations, by which one is to issue stock for the assets of the other, is exempt from qualification, prior to general solicitation of shareholder approval for such agreement. [Corps.C. § 25103(a)]

(2) [8:717] **Issuance:** But the actual issuance of securities for assets constitutes an "exchange" of the securities, and therefore must be qualified, by permit, unless exempt. [Corps.C. §§ 25120-25121]

(3) [8:718] **Possible exemptions:** The only apparent exemptions from qualification would be the "nonresident shareholders exemption" under Corps.C. § 25103(c) (*see ¶ 8:289.1*) and the "limited exchange transaction exemption" under Corps.C. § 25103(h) (*see ¶ 8:289.2*).

[8:719] *Reserved.*

(4) [8:720] **Possible preemption:** Of course, federal law may *preempt* California qualification requirements. *See ¶ 8:153., 5:18.5 ff.*

(5) [8:721] **Soliciting shareholder approvals:** If the issuance is not exempt, and shareholders of either corporation are required to approve the transaction, any materials distributed to solicit their approval must be approved in advance by the Financial Protection and Innovation Commissioner. [Commr. Rule 260.140.60, *¶ 8:160*]

(6) [8:722] **Qualification procedure:** *See ¶ 5:315 ff.*

[8:723 - 8:750] *Reserved.*

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 8-E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

E. Dissolution and Liquidation

1. Voluntary Dissolution
- a. [8:752] Who may elect to dissolve
  - (1) [8:753] Shareholder action
    - (a) [8:754] Articles may not require supermajority
  - (2) [8:755] Board action
    - (a) [8:756] Articles may not require supermajority
  - (3) [8:757] Incorporator action
- b. Procedure for voluntary dissolution
  - (1) [8:758] By shareholder action
  - (2) [8:759] By (alternative) director action
    - (a) [8:760] Streamlined procedure for inactive corporation less than one year old
  - (3) [8:761] Certificate of election to dissolve filed with Secretary of State
    - (a) [8:763] Certificate *not* required where all shareholders approve dissolution
  - (4) [8:764] Notice to other shareholders and creditors
  - (5) [8:765] Court jurisdiction over winding up
    - (a) [8:766] Shareholders ordinarily not parties
- c. [8:771] Effect of commencing dissolution
- d. [8:773] Equal shareholder seeking dissolution can be "bought out"
  - (1) [8:774] Formal meeting and dissolution vote required
  - (2) [8:774a] Procedure to fix purchase price
- e. [8:775] Revocation of election
- f. [8:776] Liquidation and winding up corporate affairs; procedures for completing dissolution

2. [8:791] Involuntary Dissolution
- a. [8:792] Grounds for involuntary dissolution
  - (1) [8:793] Abandonment of business
  - (2) [8:794] Directors deadlocked
    - (a) [8:795] Provisional director may be appointed
  - (3) [8:796] Shareholders deadlocked
    - (a) [8:797] Compare—shareholder dissension
      - 1) [8:798] Comment
    - (b) [8:799] Compare—no board deadlock
  - (4) [8:800] Fraud or mismanagement
    - (a) [8:801] Fraud or unfairness not gauged by minority shareholders' expectations

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- (5) [8:802] Protection of shareholders in closely-held corporations
- (6) [8:803] Expiration of corporate term
- (7) [8:804] Grounds for action by Attorney General
  - (a) [8:805] Prior warning required
- b. [8:811] Who may commence action to dissolve corporation
  - (1) [8:812] Directors
  - (2) [8:813] Shareholders
    - (a) [8:814] Corporate "equity"
      - 1) [8:814.1] Preferred stock with liquidation preference
      - 2) [8:814.2] Nonstock instruments convertible into stock excluded
    - (b) [8:815] Effect
    - (c) [8:816] Right of intervention
  - (3) [8:817] Attorney General
  - (4) [8:818] Persons authorized by articles
  - (5) [8:819] Compare—creditors may intervene
    - (a) [8:820] Other creditor remedies available
- c. Procedural requirements
  - (1) [8:831] Verified complaint
  - (2) [8:832] Venue
  - (3) [8:834] Suit by Attorney General
    - (a) [8:835] Prior warning
    - (b) [8:836] Service of process
    - (c) [8:837] Publication of notice
- d. Relief available
  - (1) [8:841] Receiver
    - (a) [8:842] Comment
  - (2) [8:843] Injunction
  - (3) [8:845] Provisional director
    - (a) [8:846] Not dependent on articles
    - (b) [8:847] Purpose
    - (c) [8:848] Qualifications
      - 1) [8:849] Professional corporations
    - (d) [8:850] Compensation
    - (e) [8:851] Same rights as elected directors
    - (f) [8:852] Quasi-judicial immunity?
  - (4) [8:853] Order for liquidation and dissolution
- 3. [8:854] Administrative Dissolution
- 4. [8:861] Avoiding Involuntary Dissolution by Purchasing Shares of Shareholder Seeking Dissolution
  - a. [8:863] Initiating the "buy-out" proceeding
    - (1) [8:864] Plaintiff's ability to dismiss dissolution action
  - b. [8:865] Payment in cash
  - c. [8:866] Fair value
    - (1) [8:867] Valuation date
    - (2) [8:868] Possibility of sale as going business
      - (a) [8:869] *Hypothetical* considerations required
        - 1) [8:870] Rationale
      - (b) [8:871] Fact question
    - (3) [8:872] Valuing closely-held shares
      - (a) [8:873] Determining "investment value"

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- (4) [8:873.6] Includes value of pending derivative (and other) litigation
  - (a) [8:873.7] Deferral of valuation pending judgment in derivative action generally not feasible
  - (b) [8:873.8] Assignment of derivative action to plaintiff/selling shareholder not feasible
- (5) [8:874] Offset for damages
- (6) [8:876] No devaluing minority shares for lack of control
  - (a) [8:877] Compare—sale of controlling shares
- (7) [8:878] No devaluing shares for risk shareholder could destroy goodwill
- (8) [8:879] No deduction for taxes payable by corporation on liquidation

d. [8:880] No right to interest

e. [8:881] Court proceedings to fix purchase price
- (1) [8:882] Bond required
- (2) [8:883] Appraisal proceedings
  - (a) [8:884] Summary proceeding
  - (b) [8:884.1] Appraisers' determination
  - (c) [8:885] Hearing de novo
- (3) [8:885.1] Parties may stipulate to adding new parties
- (4) [8:886] Court order
  - (a) [8:886.1] Order not automatically stayed by appeal
- (5) [8:887] “Backing out” of purchase
- (6) [8:888] Effect of corporate bankruptcy following court order
- (7) [8:888a] *Forms*

5. [8:901] Liquidation and Winding Up Corporate Affairs

a. [8:902] Responsibility of board of directors
- (1) [8:903] Effect of vacancies on board
- (2) [8:904] Court's power to determine composition of board
- (3) [8:905] Court's power to appoint non-directors to handle winding up

b. [8:907] Statutory authority re winding up

c. [8:909] Notice of liquidation
- (1) [8:910] When notice to be given

d. [8:911] Notice to creditors to present claims
- (1) [8:912] Publication and mailing requirements
- (2) [8:913] Time limit for submitting claim
  - (a) [8:914] Late claims
- (3) [8:915] Effect of creditors' failure to file

e. Filings with governmental agencies
- (1) [8:916] Federal income tax—IRS Form 966
- (2) [8:917] California franchise taxes—final return
- (3) [8:918] Corporate employers—unemployment/disability reports

f. [8:931] Payment or provision for debts
- (1) [8:932] Deposit with State Controller
- (2) [8:933] Assumption of liability by third person
  - (a) [8:934] In connection with sale of corporate assets
    - 1) [8:935] Compare—liability imposed on successor by operation of law
  - (b) [8:936] Shareholders' assumption of liability limited to distribution received
- (3) [8:938] In proceedings subject to court supervision
  - (a) [8:939] Secured claims
  - (b) [8:940] Claims not matured; contingent claims
  - (c) [8:941] Disputed claims
- (4) [8:942] Director liability to creditors

- (5) [8:943] "Responsible person" liability for unpaid sales taxes
- g. [8:944] Distributions to shareholders
  - (1) [8:945] Manner of distribution
    - (a) [8:946] Deposit with State Controller in lieu of payment
  - (2) [8:947] Shares with liquidation preference
    - (a) [8:948] Limitation—distributions in reorganization
  - (3) [8:949] Effect of unpaid creditor claims
    - (a) [8:950] Creditor remedy
    - (b) [8:951] Joinder
    - (c) [8:952] Contribution
- h. [8:961] Procedures for completing dissolution
  - (1) [8:962] Voluntary dissolutions—certificate of dissolution
    - (a) [8:964] Effect of filing
      - 1) [8:965] Certificate irrevocable
      - 2) [8:966] Limitations period triggered for claims against shareholders
    - (b) [8:969] Submitting final tax return
      - 1) [8:970] Avoiding minimum tax after cessation of business
  - (2) [8:981] Voluntary dissolutions—short-form certificate for inactive corporation less than one year old
    - (a) [8:982] Filing of certificate
  - (3) [8:991] Involuntary dissolutions—court order
    - (a) [8:992] Content of order
    - (b) [8:993] Effect of order
- i. [8:994] Further winding up after dissolution
  - (1) [8:995] Pending litigation
  - (2) [8:996] Omitted assets
  - (3) [8:996.1] Exercise of attorney-client privilege
    - (a) [8:996.2] "Defunct" corporation
  - (4) [8:996.3] Derivative action permitted
- j. [8:997] Reinstatement of dissolved corporation only upon court order
  - (1) [8:997.1] Procedure
  - (2) [8:997.2] Grounds for reinstatement
  - (3) [8:997.3] Loss of corporate name—amendment of articles to adopt new name
  - (4) [8:997.4] Effective date
- k. [8:998] Postdissolution lawsuits against corporation
  - (1) [8:999] Compare—California law not applicable to foreign corporation
  - (2) [8:1006] Quiet title actions
  - (3) [8:1007] Service of process
    - (a) [8:1007.1] No relief from default where agent served
- l. [8:1008] Shareholder liability following dissolution
  - (1) [8:1010] Maximum four-year statute of limitations
  - (2) [8:1011] Shareholders sued in corporate name
    - (a) [8:1012] Unpaid creditor claims
    - (b) [8:1013] Quiet title actions

6. [8:1041] Duty to Employees in Effecting Layoffs and Plant Closings
- a. [8:1042] Federal WARN Act
  - (1) [8:1043] Employers subject to WARN Act
    - (a) [8:1043.1] Separate corporations as "single employer"
    - (b) [8:1044] Compare—fiduciary liquidating bankrupt business
  - (2) [8:1045] When advance notice required

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [8:1046] “Plant closing”
1) [8:1046.1] “Single site of employment”
a) [8:1046.2] Mobile and “outstationed” workers
(b) [8:1047] “Mass layoff”
(c) [8:1048] “Employment loss”
1) [8:1048.1] Voluntary departure
(d) [8:1049] Exceptions
1) [8:1049.1] Employees hired by purchaser of business
2) [8:1050] Employees offered a transfer
3) [8:1051] Natural disasters
4) [8:1052] Closing of temporary facility; temporary employees
5) [8:1053] Government-ordered shutdowns
6) [8:1054] Strikes or lockouts
(3) Notice requirements
(a) [8:1061] 60 days' notice normally required
(b) [8:1062] Reduction in notice period
1) [8:1063] Unforeseen business circumstances
2) [8:1064] COVID-19 pandemic and business shutdowns
a) [8:1064.1] Labor Department guidance
b) [8:1064.2] COVID-19 pandemic-related litigation
3) [8:1065] Faltering company
(c) [8:1066] Contents of notice
(d) [8:1067] Procedure
(e) [8:1068] Responsibility for providing notice upon sale of “business”
1) [8:1069] Sale itself *not* a WARN Act event
2) [8:1070] “Piecemeal” sales—no purchaser duty to remaining employees where business continues
3) [8:1071] Compare—asset sales
(4) Employer liability for noncompliance
(a) [8:1076] Employees' backpay and benefits
1) [8:1077] Trade union as plaintiff
2) [8:1078] Limitations period for damages actions
(b) [8:1079] Civil penalty to local government
(c) [8:1080] Employer's “good faith” as mitigating factor
b. [8:1091] California law
(1) [8:1092] Employers subject to California Act
(a) [8:1093] Subsidiaries
(b) [8:1094] Determining number of employees
1) [8:1095] Not seasonal employees
(c) [8:1096] Compare—WARN Act
(2) [8:1097] Notice requirement—in general
(a) [8:1098] Exceptions—disasters
(b) [8:1099] Exception—faltering company
(c) [8:1099.1] Suspension during COVID-19 pandemic
(3) [8:1100] Covered events
(a) [8:1101] “Mass layoff”
1) [8:1102] Length of layoff?
2) [8:1103] Compare—WARN Act
(b) [8:1104] “Relocation”

1) [8:1105] Compare—WARN Act
(c) [8:1106] "Termination"
1) [8:1107] Compare—WARN Act
(d) [8:1108] Limitation—exempt closings and layoffs
(4) [8:1116] Content of notice
(5) [8:1117] Civil liability for failure to provide notice
(a) [8:1118] 60-day maximum
(b) [8:1119] Set-offs
(c) [8:1126] Enforcement
1) [8:1127] Attorney fees
(6) [8:1128] Civil penalty
(a) [8:1129] Avoidance
(b) [8:1130] Reduction
7. [8:1151] Tax Effects of Dissolution
a. [8:1152] Tax consequences to shareholders
(1) [8:1155] Requirement of complete liquidation
(2) [8:1156] When gain or loss recognized
(a) [8:1157] Comment
(b) [8:1158] Deferral or shifting of gain through sale of shares on installments
(3) [8:1166] Tax-free dissolution of subsidiary
(a) [8:1169] Basis of assets received
(b) [8:1170] Section 338 election
b. [8:1176] Tax consequences to corporation
(1) [8:1177] Limitations on recognition of loss
(2) [8:1178] Converting from C corporation to S corporation
8. [8:1179] Compare—Administrative Dissolution
a. [8:1180] Purpose
b. Procedure
(1) [8:1181] Notice to corporation
(2) [8:1182] Dissolution where corporation fails to object
(3) [8:1183] Objection by corporation; revivor (reinstatement)
c. [8:1184] Effect of dissolution
(1) [8:1185] Abatement of taxes
(2) [8:1186] No discharge of other liabilities

[8:751] There are various ways in which a corporation's status as a legal entity may terminate. As discussed elsewhere, its existence may cease on expiration of the term of existence specified in its articles (*see ¶ 4:62*) or as the disappearing corporation in a merger or consolidation (*see ¶ 8:161*).

Corporate existence may also be terminated by dissolution proceedings—e.g., by *voluntary* proceedings of its shareholders, or *involuntary* court proceedings forced upon the corporation. In either case, the dissolution process involves winding up and liquidating the corporation's business and affairs. And a corporation that has been suspended for at least five years may be subject to involuntary *administrative* dissolution (analogous to a quo warranto revocation of its corporate status).

This section deals with the procedures for both voluntary and involuntary dissolution of a corporation, and the practical considerations affecting winding up of its affairs. It also deals with the tax consequences to the shareholders of liquidating distributions of corporate assets and liabilities, and tax planning to minimize these consequences.

1. Voluntary Dissolution

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a. [8:752] **Who may elect to dissolve:** Voluntary dissolution may be instituted by action of the shareholders, or in certain cases by the board of directors, or where no directors have been named, by the incorporators.

(1) [8:753] **Shareholder action:** Shareholders holding *at least 50%* of the voting shares of the corporation may elect voluntarily to wind up and dissolve the corporation at any time. [Corps.C. § 1900(a)]

(a) [8:754] **Articles may not require supermajority:** The right of a 50% shareholder to dissolve the corporation is deemed fundamental, and the articles may *not* require a greater percentage of shares. [Corps.C. § 204(a)(5); see also Corps.C. § 2603(a)(5) (SPCs); *and ¶ 4:119*]

(But, if *preferred* shares are given the right to *approve* voluntary dissolution, the articles may require approval by up to *two-thirds* of the preferred shares. See Corps.C. § 402.5(b); *¶ 4:143*.)

(2) [8:755] **Board action:** The board of directors may also elect to dissolve the corporation, but only where the corporation:

• Has issued no shares (i.e., has no shareholders); or

• Has disposed of all of its assets and been inactive for the past five years; or

• Has been adjudicated bankrupt. [Corps.C. § 1900(b); and see Corps.C. § 1906—board responsible to terminate business and wind up corporate affairs where corporate term of existence has expired]

(a) [8:756] **Articles may not require supermajority:** Only a simple majority of the board of directors is required to wind up and dissolve the corporation in such cases. Provisions in the articles (or bylaws) requiring more than a majority of the directors to constitute a quorum, or to take action, *do not apply* to voluntary dissolution of the corporation. [Corps.C. § 204(a)(5); see also Corps.C. § 2603(a)(5) (SPCs); *and ¶ 6:221.1*]

(3) [8:757] **Incorporator action:** Where no shares have been issued and no directors named, the incorporator (or a majority of the incorporators) may dissolve a corporation that has been in existence less than 12 months and that has conducted no business. [Corps.C. § 1900.5; *see discussion at ¶ 8:981 ff.*]

b. Procedure for voluntary dissolution

(1) [8:758] **By shareholder action:** Shareholders holding *50% or more* of the voting shares may commence dissolution of the corporation, either by formal resolution at a shareholders' meeting or, more typically, by written consent. [Corps.C. § 1901(b)(2), (3); see *Ovadia v. Abdullah* (1994) 24 CA4th 1100, 1109-1112, 29 CR2d 527, 532-534—informal shareholder demands do not suffice to commence dissolution (*discussed at ¶ 8:774*)]

• ***FORM:*** Written Consent of Shareholders to Voluntary Dissolution, *see Form 8:H*.

(2) [8:759] **By (alternative) director action:** In those situations where the board is authorized to commence voluntary dissolution proceedings (*see ¶ 8:755*), a formal resolution of the directors is required to initiate the dissolution process. The resolution should state the facts required to establish the board's authority to commence the dissolution proceedings (e.g., that no shares have been issued, etc.). [See Corps.C. §§ 1900(b), 1901(b)(4)]

• ***FORM:*** Directors' Resolution: Election to Wind Up and Dissolve, *see Form 8:I*.

(a) [8:760] **Streamlined procedure for inactive corporation less than one year old:** A procedure that dispenses with several interim steps in the dissolution process is available to the directors of a corporation with no shareholders and that has conducted no business since filing its articles of incorporation within the preceding 12 months. *See ¶ 8:981 ff.*

(3) [8:761] **Certificate of election to dissolve filed with Secretary of State:** The corporation is required to file "forthwith" a certificate evidencing its election to dissolve. [Corps.C. § 1901(a)]

The certificate must set forth facts showing that the election to dissolve was duly made by the shareholders or directors (*see ¶ 8:752 ff.*). It must be an officers' certificate (*see ¶ 8:82, 8:189.1*) or signed and verified by a majority of the board or by one or more shareholders authorized by 50% or more of the voting shareholders. [Corps.C. § 1901(b)]

• ***FORM:*** The Secretary of State's standard form Certificate of Election to Wind Up and Dissolve (ELEC STK) is available online at the Secretary of State's website (*www.sos.ca.gov*).

[8:762] ***Reserved.***

(a) [8:763] **Certificate *not required where all shareholders approve dissolution:*** Where the election to dissolve is made by the vote of *all outstanding shares*, and a statement to that effect is inserted in the *certificate of dissolution* (*discussed at ¶ 8:962 ff.*), no separate certificate of election to wind up and dissolve need be filed. [Corps.C. § 1901(c)]

(4) [8:764] **Notice to other shareholders and creditors:** Promptly following commencement of voluntary dissolution proceedings (by shareholders *or* directors), the board of directors must mail notice:

• To all shareholders who did not vote in favor thereof or sign a consent thereto; *and also*

• "To all *known* creditors and claimants whose addresses appear on the records of the corporation." [Corps.C. § 1903(c); *see ¶ 8:909 ff.*]

FORM: Notice of Commencement of Voluntary Dissolution, *see Form 8:J*.

(5) [8:765] **Court jurisdiction over winding up:** If disputes arise in the course of winding up and liquidating the corporation, the superior court can take jurisdiction and make whatever orders are necessary for "the protection of any parties in interest"; e.g., the shareholders and creditors. [Corps.C. § 1904]

A petition seeking such court orders may be filed by:

• The corporation; or

• Any holder or holders of 5% or more of any class of outstanding shares (or *any* shareholder of a statutory close corporation); or

• Any three creditors of the corporation. [Corps.C. § 1904]

(a) [8:766] **Shareholders ordinarily not parties:** Shareholders are not parties to the proceeding unless they are named as defendants or they intervene. And shareholders cannot be named as defendants unless the corporation seeks affirmative relief against them. [*In re FairWageLaw* (2009) 176 CA4th 279, 286, 97 CR3d 652, 657]

Consequently, if the corporation uses the dissolution proceeding to assert a claim seeking a monetary judgment or other affirmative relief against a shareholder, the court may not adjudicate the claim unless the shareholder has been *named as a defendant*. This is so even where the shareholder intervened in the proceeding. [*In re FairWageLaw*, supra, 176 CA4th at 287-288, 97 CR3d at 658]

[8:767 - 8:770] ***Reserved.***

c. [8:771] **Effect of commencing dissolution:** The dissolution proceeding commences upon the shareholder or board election. However, the corporation does not cease to exist immediately. The board of directors remains in office and has the responsibility to supervise liquidation and winding up the corporation's business and affairs (unless a court has assumed jurisdiction; *see ¶ 8:765*). [Corps.C. § 1903(c)]

Once the dissolution proceeding has commenced, the corporation must cease business operations except to the extent that it may be beneficial to continue (e.g., to preserve goodwill or going-concern value pending sale of the business or any of its assets). [Corps.C. § 1903(c)]

[8:772] ***Reserved.***

d. [8:773] **Equal shareholder seeking dissolution can be "bought out":** The Code contains an escape provision to avoid dissolution of the corporation where *just 50%* of the voting shares have voted for dissolution (typically, where there are two equal shareholders and one wants to dissolve the corporation): Unless its articles provide otherwise, the corporation has a statutory right to purchase for *cash*, at their "*fair value*," the shares of the 50% shareholder who has initiated the voluntary dissolution. Moreover, if the corporation declines to exercise this right, it may be exercised by the holder(s) of the remaining 50% of the voting shares. [Corps.C. § 2000(a), *discussed at ¶ 8:861*]

(1) [8:774] **Formal meeting and dissolution vote required:** If the voluntary dissolution procedure has not been properly initiated, neither the corporation nor its shareholders have the right to avoid dissolution through purchase of the "initiating shareholders'" stock.

Thus, calls for dissolution made during negotiations or informal meetings among the shareholders do not trigger the statutory buy-out provision. Rather, the corporate formalities of a vote through a properly noticed meeting or written consent must be observed. [*Ovadia v. Abdullah* (1994) 24 CA4th 1100, 1109-1112, 29 CR2d 527, 532-534; see also *Panakosta Partners, LP v. Hammer Lane Mgmt., LLC* (2011) 199 CA4th 612, 628-633, 131 CR3d 835, 845-851 (*discussed at ¶ 8:864*)]

(2) [8:774a] **Procedure to fix purchase price:** *See ¶ 8:881 ff.*

e. [8:775] **Revocation of election:** The process is not final until the corporation has distributed its assets to its shareholders. Until that time, the election to dissolve may be revoked by shareholders holding *more than 50%* of the voting power; or by the board, where it initiated the dissolution (*see ¶ 8:755*). [Corps.C. § 1902(a)]

To revoke the election, the corporation simply files with the Secretary of State a *"certificate of revocation,"* signed and verified in the same manner as the certificate of election to dissolve (¶ 8:761), and stating facts showing effective revocation of the earlier election. [Corps.C. § 1902(b)]

f. [8:776] **Liquidation and winding up corporate affairs; procedures for completing dissolution:** *See ¶ 8:901 ff.*

[8:777 - 8:790] ***Reserved.***

2. [8:791] **Involuntary Dissolution:** A court may order the dissolution of a corporation against its will (i.e., involuntarily) under Corps.C. § 1800 et seq.

a. [8:792] **Grounds for involuntary dissolution:** The grounds upon which the court may order a corporation dissolved are:

(1) [8:793] **Abandonment of business:** The corporation has abandoned its business for more than one year. [Corps.C. § 1800(b)(1)]

(2) [8:794] **Directors deadlocked:** Where there is an even number of directors who are equally divided and unable to agree on management of corporate affairs; *and* the shareholders are unable to break the deadlock because the voting shares are so equally divided that they cannot elect an uneven board; *and* as a result of the deadlock, the corporation's business cannot be conducted advantageously or there is a risk that its property or business may be impaired. [Corps.C. § 1800(b)(2)]

(a) [8:795] **Provisional director may be appointed:** Where deadlock is the *only* ground asserted for dissolution, dissolution may be avoided by the court's appointment of a provisional director to break the deadlock; *see ¶ 8:845*. [Corps.C. § 1802]

(3) [8:796] **Shareholders deadlocked:** There is internal dissension among the shareholders, and two or more factions are so deadlocked that it is impairing the corporation's ability to conduct business "with advantage to its shareholders"; or, because of the deadlock, the shareholders have been unable at the past two annual shareholders' meetings to fill vacancies on the board of directors (or to replace directors whose terms otherwise would have expired). [Corps.C. § 1800(b)(3)]

(a) [8:797] **Compare—shareholder dissension:** Despite shareholder dissension, the requisite shareholder *deadlock* does *not* exist where a majority faction has the power to elect a majority of the directors or otherwise conduct the corporation's business to the advantage of its shareholders. [*Belio v. Panorama Optics, Inc.* (1995) 33 CA4th 1096, 1105-1106, 39 CR2d 737, 742—no deadlock where corporation with 54% shareholder was able to conduct business]

1) [8:798] **Comment:** Of course, a deadlock can occur even where one faction holds a majority of the voting shares if a *supermajority* or *unanimous vote* on important matters is required but cannot be attained. [See *Belio v. Panorama Optics, Inc.* (1995) 33 CA4th 1096, 1104, 39 CR2d 737, 741]

(b) [8:799] **Compare—no board deadlock:** Shareholder deadlock may justify dissolution even though the *board* is *not* deadlocked. For example, where two equal shareholders, A and B, have established a 3-person board of directors, including themselves and a trusted third person, C. If A and B have a falling out and C sides with either of them, there is no deadlock on the board. Moreover, neither A nor B could replace C, so the existing board continues indefinitely. In such a case, dissolution could not be based on board deadlock, but *can* be based on shareholder deadlock.

(4) [8:800] **Fraud or mismanagement:** Those in control of the corporation have committed or knowingly countenanced "persistent and pervasive" fraud, mismanagement or abuse of authority or persistent unfairness toward any shareholder;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

or the corporation's property is being misapplied or *wasted* by its directors or officers. [Corps.C. § 1800(b)(4); *Buss v. J.O. Martin Co.* (1966) 241 CA2d 123, 134-135, 50 CR 206, 213-214]

(a) [8:801] **Fraud or unfairness not gauged by minority shareholders' expectations:** The controlling shareholders' failure to meet the minority shareholders' reasonable expectations in managing the company is not grounds for involuntary dissolution under Corps.C. § 1800(b)(4). Instead, the test is the controlling shareholders' *demonstrated misconduct* against the minority. [*Bauer v. Bauer* (1996) 46 CA4th 1106, 1113, 1115, 54 CR2d 377, 381-383]

(5) [8:802] **Protection of shareholders in closely-held corporations:** If the corporation has *35 or fewer* shareholders, liquidation is reasonably necessary for protection of the rights or interests of the complaining shareholder or shareholders. [Corps.C. § 1800(b)(5)]

A showing under this standard should not require the same level of misconduct or abuse as is required to satisfy the specific alternative grounds for dissolution (e.g., persistent and pervasive management fraud, mismanagement, abuse of authority, etc.; ¶ 8:800). [See *Stumpf v. C.E. Stumpf & Sons, Inc.* (1975) 47 CA3d 230, 234-235, 120 CR 671, 674 (decided under similar provisions of prior law); *Bauer v. Bauer* (1996) 46 CA4th 1106, 1116-1118, 54 CR2d 377, 383-384]

Nevertheless, involuntary liquidation is a drastic remedy and will not be ordered on the grounds of shareholder disagreements over business judgments or even extreme hostility among the shareholders … especially where the complaining shareholders are represented on the board and are receiving dividends. [*Stuparich v. Harbor Furniture Mfg., Inc.* (2000) 83 CA4th 1268, 1277-1280, 100 CR2d 313, 318-320]

(6) [8:803] **Expiration of corporate term:** The period for which the corporation was formed has terminated without extension of such period (and the directors have not taken steps to terminate the corporation's business and affairs). [Corps.C. §§ 1800(b)(6), 1906]

(7) [8:804] **Grounds for action by Attorney General:** In addition, there are several grounds upon which the Attorney General may sue for involuntary dissolution of a corporation:

• A "serious offense" against any of the statutes regulating corporations;

• Fraudulent abuse or usurpation of corporate privileges or powers;

• Violating the law by some act or default that is ground for forfeiture of its charter;

• Failure to pay the franchise tax or other corporate tax for five years. [Corps.C. § 1801(a)]

(a) [8:805] **Prior warning required:** If the ground is one that can be corrected (e.g., by amendment of the corporation's articles or other action), the Attorney General must give the corporation at least 30 days' written notice before filing suit. The corporation can avoid dissolution by instituting corrective action during the 30-day period and prosecuting same diligently thereafter. [Corps.C. § 1801(b)]

[8:806 - 8:810] *Reserved.*

b. [8:811] **Who may commence action to dissolve corporation:** A complaint for involuntary dissolution may be filed only by the following persons:

(1) [8:812] **Directors:** *One-half* or more of the directors of the corporation may file an action for involuntary dissolution. [Corps.C. § 1800(a)(1)]

(2) [8:813] **Shareholders:** A suit for involuntary dissolution may be brought by shareholders holding at least *one-third* of:

• The *total number of outstanding shares* (assuming conversion of any preferred shares convertible into common shares), *excluding* shares held by anyone who personally participated in any fraud or mismanagement asserted as ground for dissolution;

• The outstanding *common* shares, again *excluding* shares held by anyone who personally participated in any fraud or mismanagement asserted as ground for dissolution; *or*

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The "equity" of the corporation (*see ¶ 8:814 ff.*). [Corps.C. § 1800(a)(2); *Kline Hawkes Calif. SBIC, L.P. v. Sup.Ct. (Idealab)* (2004) 117 CA4th 183, 194-195, 11 CR3d 581, 589; also see *Simon v. Steelman* (1990) 224 CA3d 1002, 1005-1006, 274 CR 218, 219-220—*former* shareholder lacked standing to bring action for involuntary dissolution]
Alternatively, *any* shareholder (regardless of the size of the shareholder's holdings) may bring an involuntary dissolution action if dissolution is sought either:

• Of a *statutory close corporation; or*

• On the ground that the corporation's term of existence has expired. [Corps.C. § 1800(a)(2), (3)]

(a) [8:814] **Corporate "equity":** For Corps.C. § 1800(a)(2) purposes, the "equity" of the corporation is the value of the *property* of the corporation less its *debts*, or, stated otherwise, the difference between assets and liabilities ("net assets"). [*Kline Hawkes Calif. SBIC, L.P. v. Sup.Ct. (Idealab)* (2004) 117 CA4th 183, 191-192, 195, 11 CR3d 581, 586-587, 590]

Although it is not clear as of what date the net asset calculation is made (e.g., most recent corporate financial statements preceding involuntary dissolution action, date of filing complaint, later date when court makes "net asset" determination), the amount the shareholders *paid for their shares* is *not* determinative—i.e., the original capital of the corporation is not the same as "equity" for Corps.C. § 1800(a)(2) purposes. [*Kline Hawkes Calif. SBIC, L.P. v. Sup.Ct. (Idealab)*, supra, 117 CA4th at 194, 11 CR3d at 588-589]

1) [8:814.1] **Preferred stock with liquidation preference:** The holders of outstanding preferred stock (if any) are included for the purpose of determining the "equity" holders entitled to seek involuntary dissolution. Where the preferred stock has a stated liquidation preference (or priority on the net corporate assets after payment of creditors, *see ¶ 3:102*), the corporate "equity" attributable to the preferred stock is the amount of the *liquidation preference plus any accrued and unpaid dividends* (*see ¶ 3:94 ff.*). [*Kline Hawkes Calif. SBIC, L.P. v. Sup.Ct. (Idealab)* (2004) 117 CA4th 183, 192-194, 11 CR3d 581, 587-588; see Corps.C. § 2004]

2) [8:814.2] **Nonstock instruments convertible into stock excluded:** For Corps.C. § 1800(a)(2) purposes, shares representing corporate "equity" do *not* include *warrants*, *options* or convertible *debt*. Such instruments are not "shares" and its holders are not "shareholders." [*Kline Hawkes Calif. SBIC, L.P. v. Sup.Ct. (Idealab)* (2004) 117 CA4th 183, 190-191, 11 CR3d 581, 586]

(b) [8:815] **Effect:** Although there may be clear grounds for involuntary dissolution, unless *enough* shareholders or directors complain, a corporation (other than a statutory close corporation) cannot be forced into dissolution.

(c) [8:816] **Right of intervention:** Shareholders lacking enough shares to commence an action for involuntary dissolution, may nonetheless be permitted to intervene in a dissolution suit filed by others. [Corps.C. § 1800(c)]

(3) [8:817] **Attorney General:** The Attorney General, acting on the Attorney General's own information or upon complaint of a private party, may sue to dissolve a corporation on the grounds enumerated in Corps.C. § 1801(a). *See ¶ 8:804*.

(4) [8:818] **Persons authorized by articles:** Finally, suit may be filed by any other person expressly authorized by the corporation's articles of incorporation to file suit for involuntary dissolution. (However, this is rarely encountered.) [Corps.C. § 1800(a)(4)]

(5) [8:819] **Compare—creditors may intervene:** Note that creditors are usually *not* authorized to commence an action for involuntary dissolution of a corporate debtor. However, they are authorized to *intervene* in such an action, once filed. [Corps.C. § 1800(c)]

(a) [8:820] **Other creditor remedies available:** In any event, corporate creditors have other remedies available: e.g., an unsatisfied judgment creditor may seek the appointment of a *receiver* to take possession of the corporation's assets and properties and apply them to payment of the creditor's judgment; or may institute involuntary *bankruptcy* proceedings against the corporation. (Neither of these results in dissolution of the corporation, but that is usually of little consequence to the creditor.)

[8:821 - 8:830] ***Reserved.***

c. Procedural requirements

(1) [8:831] **Verified complaint:** Where the action is filed by a private party (rather than the Attorney General), a verified complaint is required. [Corps.C. § 1800(a)]

(Failure to verify the complaint renders it subject to motion to strike; see CCP § 436.)

• ***FORM:*** Complaint for Involuntary Dissolution, *see Form 8:K*.

(2) [8:832] **Venue:** The proper court in which to file an action for involuntary dissolution is the superior court of the county in which the corporation has its principal office. If it has no such office in California, suit should be filed in the Superior Court of Sacramento County. [Corps.C. §§ 1800(a), 177; *Capp Care, Inc. v. Sup.Ct.* (1987) 195 CA3d 504, 508, 241 CR 741, 744 (citing text)]

As with venue requirements generally, as long as the action is *commenced* in the proper county, it may thereafter be transferred to another county if such transfer serves the ends of justice and convenience of the witnesses. [See CCP § 397(c)]

[8:833] ***Reserved.***

(3) [8:834] **Suit by Attorney General:** Special statutory requirements apply in dissolution actions filed by the Attorney General:

(a) [8:835] **Prior warning:** As already mentioned, if the ground for dissolution can be corrected by the corporation (e.g., by paying taxes or amendment of its articles), the Attorney General must give at least 30 days' written notice before filing suit; and the corporation can prevent the suit by *commencing* corrective action within the 30-day period and proceeding diligently thereafter. [Corps.C. § 1801(b)]

(b) [8:836] **Service of process:** Service of process on the corporation can be made as in any civil action; *or* by simple *written notice* to the president or secretary of the corporation at the address shown on its last-filed franchise tax return. [Corps.C. § 1801(d)] (A rather unique provision.)

(c) [8:837] **Publication of notice:** The Attorney General is also required to publish notice to shareholders of the pendency of the action, at least once, in a newspaper of general circulation in the county where the suit is filed. [Corps.C. § 1801(d)]

[8:838 - 8:840] ***Reserved.***

d. Relief available

(1) [8:841] **Receiver:** The court has power to appoint a receiver to take charge of the corporation's property and business if it has reasonable ground to believe that unless it does so "the interests of the corporation and its shareholders will suffer" pending trial of the dissolution action. Such appointment can be made only after a court hearing, upon notice to the corporation. Whoever is seeking the appointment must post a bond or undertaking as required by the Code of Civil Procedure. [Corps.C. § 1803; see *Gold v. Gold Realty Co.* (2003) 114 CA4th 791, 804-805, 807-808, 8 CR3d 118, 128, 130-131]

(a) [8:842] **Comment:** Courts are generally reluctant to grant a receivership prior to trial. They regard it as a "drastic" remedy, to be utilized only in extreme cases where no other alternative (e.g., injunctions) would suffice. [See *Gold v. Gold Realty Co.* (2003) 114 CA4th 791, 807-810, 8 CR3d 118, 130-132; and further discussion in Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 9 Part II]

(2) [8:843] **Injunction:** After hearing, a court may grant such orders or injunctions as are appropriate to preserve the status quo pending trial of the dissolution action. (As stated above (¶ 8:842), judges are usually more willing to grant injunctive relief than to appoint a receiver.) [Corps.C. § 1804]

As with any injunction, the party seeking the order must show a threat of irreparable harm if the injunction is not granted, that no other remedy will be adequate, and a probability of success on the merits. [See CCP §§ 526, 527; and Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 9 Part II]

[8:844] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(3) [8:845] **Provisional director:** Where the ground for the dissolution action is that the board of directors is deadlocked (i.e., an even number of directors, equally divided; *see* *¶ 8:794*), the court has power to appoint a provisional director to break the deadlock. [Corps.C. § 1802]

(a) [8:846] **Not dependent on articles:** Such appointment may be made even if there is no vacancy on the board, and even if the articles do not authorize the added director. [Corps.C. §§ 1802, 308(a); *and see* *¶ 6:232.1*]

(b) [8:847] **Purpose:** Such appointment is often made at the outset of the dissolution action, in an effort to get the board functioning again and thus avoid the necessity for dissolution. The person appointed as provisional director is usually directed to file reports with the court as to the progress, or lack thereof, at board meetings.

(c) [8:848] **Qualifications:** A provisional director must be an impartial person who is neither a shareholder nor creditor of the corporation (nor related to any of the other directors). [Corps.C. § 308(c)]

1) [8:849] **Professional corporations:** Moreover, a provisional director of a professional corporation must have the qualifications required of the other directors—e.g., a provisional director of a medical corporation must have a medical license. [*Marik v. Sup.Ct.* (1987) 191 CA3d 1136, 1140, 236 CR 751, 754]

(d) [8:850] **Compensation:** Provisional directors are entitled to compensation for their services, as fixed by the court (or as otherwise agreed with the corporation). [Corps.C. § 308(c)]

(e) [8:851] **Same rights as elected directors:** Until the deadlock on the board ends, or the provisional director is removed by court order or written consent of a majority of the outstanding voting shares, the provisional director has the same rights as an elected director, including the right to notice of board meetings and the power to vote at all meetings. [Corps.C. §§ 1802, 308(c)]

(f) [8:852] **Quasi-judicial immunity?** It is unclear whether provisional directors are the "alter-ego" of the appointing judge and thus cloaked with quasi-judicial immunity for their acts as provisional director.

(4) [8:853] **Order for liquidation and dissolution:** Upon trial of the involuntary dissolution action, the court may decree a winding up and dissolution of the corporation, or it may make such other orders and issue such injunctions as justice requires. [Corps.C. § 1804]

3. [8:854] **Administrative Dissolution:** *See* *¶ 8:1179 ff.*

[8:855 - 8:860] ***Reserved.***

4. [8:861] **Avoiding Involuntary Dissolution by Purchasing Shares of Shareholder Seeking Dissolution:** Unless provided otherwise in (a) its articles or (b) an agreement between two or more shareholders and referred to in the articles or (c) a close corporation shareholders agreement (*see* ¶ 3:232.3), a corporation has the statutory right to avoid liquidation and involuntary dissolution by purchasing for *cash*, at their "fair value," the shares of any shareholder who has filed suit to dissolve the corporation. Moreover, if the corporation declines to exercise such right, the holders of 50% or more of the voting shares of the corporation may do so. [Corps.C. § 2000(a)]

Compare: The same "buy-out" right exists where a shareholder (or shareholder group) with *just 50%* of the shares institutes *voluntary* dissolution proceedings. But neither the corporation nor the remaining shareholders can exercise the buy-out right if the parties attempting to voluntarily dissolve the corporation hold *more than 50%* of the outstanding voting shares. [Corps.C. § 2000(a); *Mart v. Severson* (2002) 95 CA4th 521, 524, 115 CR2d 717, 719; *see* *¶ 8:773 ff.*]

For the corporation to make such a purchase, it must obtain approval of a majority of the voting shareholders, *excluding* the shares to be acquired. [Corps.C. § 2000(a)] Thus, e.g., where shareholders with 40% of the outstanding shares initiate involuntary dissolution proceedings, a corporate buy-out of their shares must be approved by a majority vote of the remaining 60% (i.e., over 30%).

Of course, the corporation must have retained earnings or other lawful source of funds from which to make the purchase. [Corps.C. § 500 et seq.; *see* *¶ 7:10 ff.*]

Where the corporation, or 50% or more of the shareholders, properly exercise the "buy-out" right, the following rules apply:

[8:862] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a. [8:863] **Initiating the "buy-out" proceeding:** The "buy-out" right may be triggered by filing a motion in the involuntary dissolution action to *stay the dissolution* and *appoint appraisers* pursuant to Corps.C. § 2000.

(1) [8:864] **Plaintiff's ability to dismiss dissolution action:** *Before the hearing on the motion*, the plaintiff bringing the involuntary dissolution action may still voluntarily dismiss the action (per CCP § 581), which then cuts off the corporation's and other shareholders' right to buy out plaintiff's shares. [*Kennedy v. Kennedy* (2015) 235 CA4th 1474, 1480-1485, 186 CR3d 198, 202-206; see also *Panakosta Partners, LP v. Hammer Lane Mgmt., LLC* (2011) 199 CA4th 612, 628-633, 131 CR3d 835, 845-851—minority limited partners' buyout right in response to majority limited partners' initiation of judicial dissolution under Corps.C. § 15908.02 unavailable after majority limited partners dismissed their petition for dissolution with prejudice]

However, once the motion is *granted*, the Section 2000 proceeding effectively supplants the involuntary dissolution action, and plaintiff no longer has the right to unilaterally dismiss the dissolution action. [*Ontiveros v. Constable* (2018) 27 CA5th 259, 264, 278-280, 237 CR3d 892, 894-895, 906-907; see *Go v. Pacific Health Services, Inc.* (2009) 179 CA4th 522, 530-532, 101 CR3d 736, 741-743; compare *Guttman v. Guttman* (2021) 72 CA5th 396, 412, 287 CR3d 296, 306-307—plaintiff cannot voluntarily dismiss partnership dissolution action after court orders buyout procedure (once court orders buyout procedure, partnership dissolution action is stayed and buyout procedure "goes forward in its place")]

b. [8:865] **Payment in cash:** First of all, the purchasing parties must pay cash for the shares in question—rather than promissory notes, securities or other property. [Corps.C. § 2000(a)]

c. [8:866] **Fair value:** "Fair value" means the *liquidation value* of the business as of the "valuation date"—but taking into account the possibility, if any, of sale of the entire business as a going concern in a liquidation. [Corps.C. § 2000(a); *see ¶ 1:116*]

(1) [8:867] **Valuation date:** The valuation date is the date upon which the suit for involuntary dissolution was filed (or in the case of a voluntary dissolution, the date upon which the 50% shareholders initiated the proceedings). However, in either case, upon hearing a motion brought by either party and for good cause shown, the court can designate some other date as the valuation date. [Corps.C. § 2000(f); see *Crane v. R. R. Crane Investment Corp., Inc.* (2022) 82 CA5th 748, 761-762, 298 CR3d 759, 769-770 (*further discussed at ¶ 8:880*); *Cotton v. Expo Power Systems, Inc.* (2009) 170 CA4th 1371, 1382, 89 CR3d 112, 121 (*discussed at ¶ 8:873.7*); *Trahan v. Trahan* (2002) 99 CA4th 62, 76-77, 120 CR2d 814, 825—designation of alternate valuation date is "particularly appropriate" where corporation anticipates substantial near-term revenue from nonassignable executory contracts (dictum)]

(2) [8:868] **Possibility of sale as going business:** The possibility of selling the business as a going concern must be considered in determining its "fair value." [Corps.C. § 2000(a); see *Mart v. Severson* (2002) 95 CA4th 521, 524, 115 CR2d 717, 719]

If such a sale is unlikely, the various assets of the business have to be valued piecemeal for liquidation purposes—usually resulting in a distinctly lower value. [See *Trahan v. Trahan* (2002) 99 CA4th 62, 72-74, 120 CR2d 814, 821-822 (quoting text)—liquidation valuation that excluded $650,000 future gross profits from unassignable construction contracts produced $164,000 *negative* net worth; *Brown v. Allied Corrugated Box Co.* (1979) 91 CA3d 477, 490, 154 CR 170, 178]

(a) [8:869] ***Hypothetical considerations required:*** In determining the business' value if sold as a going concern in liquidation, appraisers are not only entitled, but are *required*, to consider the manner in which the parties to a *hypothetical* sale are most likely to maximize their return. This should include "standard" *covenants not to compete* from the shareholders (as to limitations on such covenants, *see ¶ 6:401.1*). [*Mart v. Severson* (2002) 95 CA4th 521, 530-532, 115 CR2d 717, 724-725; *Trahan v. Trahan* (2002) 99 CA4th 62, 78, 120 CR2d 814, 826 (citing text); *Abrams v. Abrams-Rubaloff & Assocs., Inc.* (1980) 114 CA3d 240, 249, 170 CR 656, 661]

1) [8:870] **Rationale:** A requirement that appraisers take into account actual sale terms demanded by the shareholders (as opposed to a hypothetical sale) would cause several problems:

- It would effectively force the shareholders to negotiate with each other. Corps.C. § 2000 does not authorize the court to order such negotiations or an actual sale; "[n]or does it authorize the trial court to dictate any of the terms of the sale *other than price*." [*Mart v. Severson* (2002) 95 CA4th 521, 532, 115 CR2d 717, 725-726 (emphasis in original)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Moreover, a shareholder would be able to easily skew the appraisal by insisting on unusual or unreasonable terms. E.g., a shareholder's refusal to give a covenant not to compete could result in a substantially lower valuation. [*Mart v. Severson*, supra, 95 CA4th at 534-535, 115 CR2d at 727-728]

(b) [8:871] **Fact question:** The likelihood of selling the business intact is a factual question in each case. If the parties are unable to agree, the court will have to determine the matter in deciding the "fair value" of the shares in question. [*Brown v. Allied Corrugated Box Co.* (1979) 91 CA3d 477, 490, 154 CR 170, 178]

(3) [8:872] **Valuing closely-held shares:** Where the shares are not actively traded and have no established *market* value (i.e., are "closely-held"), their "fair value" for buy-out purposes is determined by establishing their "*investment value*" (rather than market value). [*Ronald v. 4-C's Electronic Packaging, Inc.* (1985) 168 CA3d 290, 296-300, 214 CR 225, 228-232]

(a) [8:873] **Determining "investment value":** "Investment value" is determined by applying the valuation factors set forth in IRS guidelines (see Rev.Rul. 59-60, 1959-1 CB 237, *discussed at ¶ 1:108.1*). Normally, *all* such factors must be considered. [*Ronald v. 4-C's Electronic Packaging, Inc.* (1985) 168 CA3d 290, 301, 214 CR 225, 232—closely-held shares could not be valued for buy-out by relying solely on price-earnings method]

[8:873.1 - 8:873.5] ***Reserved.***

(4) [8:873.6] **Includes value of pending derivative (and other) litigation:** A derivative claim (or other claim that may yield a potential recovery for the corporation) is a corporate asset that must be considered when determining "fair value." An appraisal (*see ¶ 8:883*) that fails to take into account the value of a derivative action is deficient; the court must either obtain an appraisal that includes a valuation of the action or conduct a hearing (¶ 8:885) to resolve the matter. [*Goles v. Sawhney* (2016) 5 CA5th 1014, 1019, 210 CR3d 261, 265 (citing text); *Cotton v. Expo Power Systems, Inc*. (2009) 170 CA4th 1371, 1380-1382, 89 CR3d 112, 119-121]

Although valuation of a pending derivative action may prove extremely difficult, the alternatives are limited:

(a) [8:873.7] **Deferral of valuation pending judgment in derivative action generally not feasible:** The court can designate the valuation date as some date other than the date upon which the involuntary dissolution action was filed (*¶ 8:867*); but the court must bear in mind that the valuation/buy-out process was intended to provide a relatively prompt resolution of the shareholders' dispute. The court should not defer the valuation date to await entry of judgment in the derivative action where doing so would inordinately prolong the buy-out. [*Cotton v. Expo Power Systems, Inc.* (2009) 170 CA4th 1371, 1382, 89 CR3d 112, 121 (noting 5-year valuation delay unreasonable)]

(b) [8:873.8] **Assignment of derivative action to plaintiff/selling shareholder not feasible:** Similarly, assignment of the derivative action to the selling shareholder as part of the buy-out is not feasible where the derivative action was brought by the selling shareholder: Once bought out, the shareholder would not satisfy the "continuous ownership" requirement for maintaining the derivative action (Corps.C. § 800(b)(1), *¶ 6:618*). [*Cotton v. Expo Power Systems, Inc.* (2009) 170 CA4th 1371, 1382, 89 CR3d 112, 121 ("it seems doubtful that the present circumstances warrant an exception to the continuous ownership requirement, when the majority shareholders have exercised their statutory right to purchase plaintiff's shares for their fair value …")]

(5) [8:874] **Offset for damages:** In some cases, a shareholder suing for involuntary dissolution thereby breaches an agreement with the other shareholders (e.g., to render services to the corporation for a fixed period of time). In such cases, the other shareholders are entitled to offset against the purchase price any damages caused by such breach (e.g., the cost of obtaining others to perform services which the shareholder had agreed to provide without charge to the corporation). [Corps.C. § 2000(a); see *Abrams v. Abrams-Rubaloff & Assocs., Inc.* (1980) 114 CA3d 240, 249, 170 CR 656, 661]

[8:875] But no such offset may be claimed where the ground for dissolution is that those in control have been guilty of "persistent and pervasive" fraud, mismanagement, etc. or misapplication or waste of corporate property. [See Corps.C. §§ 2000(a), 1800(b)(4)]

(6) [8:876] **No devaluing minority shares for lack of control:** Where a majority shareholder seeks to avoid dissolution by purchasing the shares of minority shareholders, their lack of control is *not* taken into account. Reason: Since the purchaser already has control of the corporation, control is irrelevant in valuing the minority's shares (although it clearly would be

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

relevant if the shares were placed on the open market). [*Goles v. Sawhney* (2016) 5 CA5th 1014, 1019, 210 CR3d 261, 265 (citing text); *Brown v. Allied Corrugated Box Co.* (1979) 91 CA3d 477, 486, 154 CR 170, 176]

(a) [8:877] **Compare—sale of controlling shares:** It is unclear whether a premium for control should be added in the unlikely event that *controlling* shares are purchased to avoid dissolution. [See *Brown v. Allied Corrugated Box Co.* (1979) 91 CA3d 477, 486, 154 CR 170, 176—no premium for control; and *Ronald v. 4-C's Electronic Packaging, Inc.* (1985) 168 CA3d 290, 298-300, 214 CR 225, 230-231—premium for control should be added]

(7) [8:878] **No devaluing shares for risk shareholder could destroy goodwill:** For purposes of avoiding dissolution, the business is to be valued as it exists *on the valuation date* (*¶ 8:866 ff.*), with its goodwill intact. A shareholder's threat to leave the corporation and compete with it do not reduce the value of its goodwill—even where the goodwill is attributable predominantly to the shareholder's services. Reason: The goodwill belongs to the corporation and must be reflected in the fair value determination to allow the other shareholders to obtain the true value of their stock. [*Mart v. Severson* (2002) 95 CA4th 521, 531-532, 115 CR2d 717, 724-725; *Brown v. Allied Corrugated Box Co.* (1979) 91 CA3d 477, 486, 154 CR 170, 176]

(8) [8:879] **No deduction for taxes payable by corporation on liquidation:** The "fair value" of the plaintiff's shares is determined without regard to taxes payable by the corporation in the event of liquidation. Reason: If the corporation or other shareholders buy the plaintiff's shares, dissolution is avoided, so the corporation will not have to pay such taxes. [*Abrams v. Abrams-Rubaloff & Assocs., Inc.* (1980) 114 CA3d 240, 250, 170 CR 656, 661]

d. [8:880] **No right to interest:** The selling shareholders retain their shares (and the rights to dividends, etc.) until paid for. Therefore, they are *not* entitled to recover interest on the purchase price from the date of valuation under Civ.C. § 3287(a) (prejudgment interest on damages awards) or Civ.C. § 3288 (prejudgment interest for damages based on breach of noncontract obligation or on showing of oppression, fraud, or malice). [*Crane v. R. R. Crane Investment Corp., Inc.* (2022) 82 CA5th 748, 759-762, 298 CR3d 759, 767-769; *Abrams v. Abrams-Rubaloff & Assocs., Inc.* (1980) 114 CA3d 240, 251, 170 CR 656, 661 (addressing prejudgment interest under Civ.C. § 3287(a))]

e. [8:881] **Court proceedings to fix purchase price:** If the parties are unable to agree on the "fair value" of the shares in question, or the amount of any offset (¶ 8:874), the purchasing party or parties may seek a judicial determination thereof. Such determination may be made in a pending suit for involuntary dissolution; or if sought in connection with a voluntary dissolution, in a proceeding initiated for such relief. Pending its determination of the value of the shares in question, the court will *stay* any liquidation or dissolution proceedings. [Corps.C. § 2000(b); see *Crane v. R. R. Crane Investment Corp., Inc.* (2022) 82 CA5th 748, 756-758, 298 CR3d 759, 764-766; *Mart v. Severson* (2002) 95 CA4th 521, 524-525, 115 CR2d 717, 719-720]

(1) [8:882] **Bond required:** To obtain a stay of the dissolution, the purchasing parties must post a bond to cover the estimated reasonable expenses (including attorney fees) incurred by the shareholder whose shares are being purchased if the purchasing parties fail to pay the price determined by the court (*see ¶ 8:886*). [Corps.C. § 2000(b)]

(2) [8:883] **Appraisal proceedings:** The court is required to appoint three disinterested appraisers to determine the value of the shares in question. The order appointing the appraisers will prescribe the time and manner of producing evidence, if evidence is required. [Corps.C. § 2000(c)]

(a) [8:884] **Summary proceeding:** Unless the court orders otherwise, the appraisal proceedings are summary in nature. The parties do *not* have the right to depose the appraisers or to examine witnesses interviewed by them in arriving at their valuation. [*Abrams v. Abrams-Rubaloff & Assocs., Inc.* (1980) 114 CA3d 240, 248, 170 CR 656, 659]

(b) [8:884.1] **Appraisers' determination:** "The award of the appraisers, or a majority of them, when confirmed by the court, shall be final and conclusive upon all parties." [Corps.C. § 2000(c)]

Thus, the appraisers cannot act independently of each other but, rather, must confer in an attempt to reach a consensus. If a majority of the appraisers fail to agree, the court must make a de novo determination of the shares' "fair value" (¶ 8:885). [*Goles v. Sawhney* (2016) 5 CA5th 1014, 1020, 210 CR3d 261, 266—where appraisers reached 3 different amounts, court erred in "confirming" all 3 awards and simply averaging them together without conducting de novo review]

(c) [8:885] **Hearing de novo:** The court is not bound by the appraisal. The court is free to decide the matter de novo or, where the appraisers cannot agree, select among conflicting opinions. At any hearing de novo, the court may take additional evidence on the question of value or, if the award appears based on substantial evidence, may properly refuse

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

to consider any further evidence of value. [*Brown v. Allied Corrugated Box Co.* (1979) 91 CA3d 477, 491, 154 CR 170, 179; see *Goles v. Sawhney* (2016) 5 CA5th 1014, 1020, 210 CR3d 261, 266 (citing text); *Cotton v. Expo Power Systems, Inc.* (2009) 170 CA4th 1371, 1381-1382, 89 CR3d 112, 120-121]

(3) [8:885.1] **Parties may stipulate to adding new parties:** A court does not lose subject matter jurisdiction if the parties stipulate to adding new parties to the buyout proceeding that were not subject to the underlying dissolution action—even if the court erred by including the additional parties. [*Schrage v. Schrage* (2021) 69 CA5th 126, 141-144, 284 CR3d 279, 292-294]

(4) [8:886] **Court order:** The court cannot directly order the purchasing parties to pay the price set by the appraisers. But it can (and usually will) decree that *unless* the purchasing parties pay that price by a specified date, the corporation shall be wound up and dissolved. In addition, the court can order judgment against the purchasing parties and the sureties on their bond (*see ¶ 8:882*) for the *expenses* incurred in connection with the appraisal by the shareholder whose shares were to be purchased. [Corps.C. § 2000(c); see *Go v. Pacific Health Services, Inc.* (2009) 179 CA4th 522, 529-532, 101 CR3d 736, 741-743; *Cotton v. Expo Power Systems, Inc.* (2009) 170 CA4th 1371, 1381-1382, 89 CR3d 112, 120-121]

(a) [8:886.1] **Order not automatically stayed by appeal:** The filing of a notice of appeal from the trial court's order does *not* automatically stay the order. A party wishing to stay the order while pursuing an appeal must first seek a stay from the trial court. If the trial court refuses, the party may then petition the appellate court for a writ of supersedeas suspending the trial court's power to compel execution of the order pending appellate review. [*Veyna v. Orange County Nursery, Inc.* (2009) 170 CA4th 146, 154-158, 87 CR3d 658, 665-668; see *Dickson v. Rehmke* (2008) 164 CA4th 469, 475-478, 78 CR3d 874, 877-880—order is appealable and service of order triggers CRC 8.104(a) 60-day appeal deadline (decided under parallel provision governing limited liability companies but same result would appear to apply to Corps.C. § 2000); and Eisenberg, *Cal. Prac. Guide: Civil Appeals & Writs* (TRG), Ch. 7]

(5) [8:887] **"Backing out" of purchase:** The parties seeking to avoid dissolution can back out of the purchase if they feel the price fixed by the court is too high. But they no longer have the ability to contest the grounds for involuntary dissolution (*¶ 8:792 ff.*)—i.e., the dissolution *must* proceed. And they will have to pay all reasonable expenses (including attorney fees) incurred by the other parties in the appraisal process—even if those costs exceed the posted bond (*¶ 8:882*). [Corps.C. § 2000(c); see *Go v. Pacific Health Services, Inc.* (2009) 179 CA4th 522, 529-532, 101 CR3d 736, 741-743; *Trahan v. Trahan* (2002) 99 CA4th 62, 75, 120 CR2d 814, 824 (citing text); *In re Orange County Nursery, Inc.* (CD CA 2010) 439 BR 144, 152-154; compare *Schrage v. Schrage* (Cal.App. 2020) 2020 WL 4812677, *1, *5-7 (unpublished decision)—party seeking dissolution not entitled to recover from parties backing out of purchase attorney fees and expenses party seeking dissolution incurred to obtain injunctive relief during appraisal process to protect business from alleged misconduct by backing-out parties]

(6) [8:888] **Effect of corporate bankruptcy following court order:** Where the corporation files for bankruptcy following entry of the trial court's order, the bought-out shareholders are treated as *creditors* with a claim against the corporation for the value of their shares (plus any amount by which their expenses exceed the posted bond, ¶ 8:882); they are no longer treated as equity holders for bankruptcy law purposes. [*In re Orange County Nursery, Inc.* (CD CA 2010) 439 BR 144, 149-154—noting that "[w]hether the appropriate valuation is the appraised value or some other value is a matter for the Bankruptcy Court to determine"]

(7) [8:888a] ***Forms:***

• Notice of Motion to Stay Dissolution and Fix Value of Shares of Shareholders Seeking Dissolution, *see Form 8:L*.

• Order Staying Dissolution and Appointing Appraiser to Determine Value of Shares, *see Form 8:M*.

• Order for Winding Up and Dissolution if Appraised Value of Shares Not Paid, and for Award of Expenses, *see Form 8:N*.

[8:889 - 8:900] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

5. [8:901] **Liquidation and Winding Up Corporate Affairs:** Neither a voluntary election to dissolve, nor court order for involuntary dissolution, automatically terminates the corporation's existence or its business. Rather, it remains in existence to liquidate and wind up (really, "wind down"): i.e., to pay or make provision for payment of its debts; to distribute its remaining assets to its shareholders; and to file a certificate of dissolution with the Secretary of State. [See *Trahan v. Trahan* (2002) 99 CA4th 62, 72, 120 CR2d 814, 821 (quoting text)]

a. [8:902] **Responsibility of board of directors:** Whether a dissolution proceeding is voluntary or involuntary, the board of directors normally is responsible for winding up the corporation's business and affairs. [Corps.C. §§ 1805(b), 1903(b)]

(1) [8:903] **Effect of vacancies on board:** If there is a vacancy on the board, it can be filled during the dissolution process —either by shareholder election or by the remaining directors. [Corps.C. §§ 2002, 305; *see ¶ 6:18*]

(2) [8:904] **Court's power to determine composition of board:** If there is a dispute as to membership of the board, or if the directors refuse or are unable to act, the court has power to intervene. On motion of any interested person, and after notice and hearing, the court can determine the composition of the board; and if necessary, appoint persons to serve as directors to wind up the corporate affairs. [Corps.C. § 2003]

(3) [8:905] **Court's power to appoint non-directors to handle winding up:** For good cause shown, the court in an involuntary dissolution action may appoint persons *other than* directors to supervise the winding up (e.g., where the dissolution is based on the directors' previous mismanagement). [Corps.C. § 1805(b)]

Similarly, if the parties seek judicial assistance in connection with a *voluntary* dissolution, the court "may make such orders as to any and all matters concerning the winding up of the affairs of the corporation and for the protection of its shareholders and creditors as justice and equity may require" (which doubtless includes the power to appoint persons other than directors to supervise winding up). [Corps.C. § 1904; *and see ¶ 8:765*]

[8:906] ***Reserved.***

b. [8:907] **Statutory authority re winding up:** The directors (or other persons appointed to wind up the corporation's affairs) are empowered by statute to take all actions reasonably necessary for winding up its affairs. [Corps.C. § 2001; see *Trahan v. Trahan* (2002) 99 CA4th 62, 72, 120 CR2d 814, 821-822 (citing text)]

This includes, without limitation, the following specific powers: [See Corps.C. § 2001(a)-(h)]

- Continuing the corporate business to the extent necessary to facilitate its sale or disposal of its assets;
- Entering into and performing contracts in the corporate name which would be beneficial to preserving its goodwill or the going business value of its business or assets;
- Electing officers, and employing agents and attorneys to wind up the corporate affairs;
- Suing or defending lawsuits, and settling or compromising claims for or against the corporation;
- Collecting any amounts unpaid on share subscriptions or for unlawful distributions previously made by the corporation; and
- Selling any or all of the corporate assets (other than to control persons), on such terms as deemed reasonable, *without* the necessity of shareholder approval where the sales are for cash. (However, if the consideration is other than money, shareholder approval may be required.) [See Corps.C. § 2001(a)-(h); *Trahan v. Trahan*, supra, 99 CA4th at 72, 120 CR2d at 821 (citing text)]

[8:908] ***Reserved.***

c. [8:909] **Notice of liquidation:** Both in voluntary and involuntary liquidations, the directors are required to mail notice that the corporation is in liquidation to all creditors and claimants whose addresses appear on the records of the corporation; and to all shareholders (other than those who consented to the dissolution proceeding). [Corps.C. §§ 1805(c), 1903(c); *see ¶ 8:764*]

(1) [8:910] **When notice to be given:** Such notice must be mailed promptly upon *commencement* of the wind-up proceedings; i.e., upon the filing of a voluntary election to dissolve, or upon entry of the court order for involuntary winding up of the corporation. [Corps.C. §§ 1805(a), (c), 1903(c); *see ¶ 8:764*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

d. [8:911] **Notice to creditors to present claims:** In addition to the mailed notice required above (¶ 8:909), in dissolution proceedings *subject to court supervision*, the court *may* set a time limit within which all creditor claims must be submitted, and then require that notice be published to all creditors to present their claims within that period. [Corps.C. § 1807(a)]

FORM: Notice to Creditors to Present Claims, *see Form 8:O*.

(1) [8:912] **Publication and mailing requirements:** The notice to creditors must be published at least once a week for three consecutive weeks in a newspaper of general circulation in the county where the dissolution proceeding is pending. In addition, a copy of the notice must be mailed to each person shown as a creditor or claimant on the corporation's records at such person's last known address. [Corps.C. § 1807(b)]

(2) [8:913] **Time limit for submitting claim:** The time limit for submitting proof of claims is set by the court, but must be not less than four months, nor more than six months after the first publication of notice to creditors (unless it appears by affidavit that the corporation has no unpaid bills or claims, in which event the time limit can be three months). [Corps.C. § 1807(a)]

(a) [8:914] **Late claims:** The court has power to allow a claim to be filed late if it is shown by affidavit that the creditor did not receive notice because of absence from the state or other cause. But late claims cannot be filed after the corporation's assets have been distributed to the shareholders. [Corps.C. § 1807(a)]

(3) [8:915] **Effect of creditors' failure to file:** Creditors and claimants who fail to present their claims to the court within the time limit set by the court are barred from participating in any distribution of assets made by the court. [Corps.C. § 1807(a)]

Moreover, they are also apparently barred from later asserting their claims against the shareholders to whom the corporate assets have been distributed (*see ¶ 8:1008*).

e. Filings with governmental agencies

(1) [8:916] **Federal income tax—IRS Form 966:** Within *30 days* of adopting a resolution or plan of dissolution, the corporation must file IRS Form 966 with the Internal Revenue Service. A copy of the resolution or plan, certified by an appropriate corporate officer, must accompany the form. [IRC § 6043(a); Treas.Reg. § 1.6043-1]

An additional Form 966 must be filed within 30 days of any *amendment or supplement* to the resolution or plan of dissolution. [Treas.Reg. § 1.6043-1(a)]

FORM: IRS Form 966 (Corporate Dissolution or Liquidation) is available online at the IRS website (*www.irs.gov*).

(2) [8:917] **California franchise taxes—final return:** A corporation that is *not* part of a "unitary group" must file a final tax return with the Franchise Tax Board by the 15th day of the fourth month after its date of dissolution (i.e., the date its certificate of dissolution is filed with the Secretary of State), which is the same due date of its federal tax return if a federal tax return is required. "Unitary group" corporations must file with the Franchise Tax Board within two months and 15 days after the close of the *group's taxable year* (i.e., the ordinary state filing deadline). [Rev. & Tax.C. §§ 18601(c), 24634; IRC § 6072(a); Treas.Reg. § 1.6072-2T(a); *see ¶ 8:969*]

(3) [8:918] **Corporate employers—unemployment/disability reports:** Within *10 days* of commencing dissolution proceedings or "quitting business," corporate employers making state unemployment/disability contributions must file a return and report of wages of its workers with the State Employment Development Department. (A maximum 30-day extension may be obtained upon a showing of "good cause.") [Unemp.Ins.C. § 1116(a)(2), (c)]

[8:919 - 8:930] ***Reserved.***

f. [8:931] **Payment or provision for debts:** It is the responsibility of the directors or others appointed to wind up the corporation's affairs to determine that all the corporation's known debts and liabilities have been paid or "adequately provided for" at the time the assets are distributed. [Corps.C. §§ 2004, 2005(a)]

(1) [8:932] **Deposit with State Controller:** If any creditor's whereabouts are unknown, or the existence or amount of the debt is contingent or disputed, the corporation may deposit the maximum amount of the claim with the State Controller "in trust" for the benefit of those lawfully entitled thereto. [Corps.C. § 2008]

(2) [8:933] **Assumption of liability by third person:** Debts or liabilities are also deemed "adequately provided for" if payment has been assumed or guaranteed by one or more financially responsible institutions or persons … *provided* the

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

board was acting in good faith and with reasonable care in determining the financial responsibility of such institution or person. [Corps.C. § 2005(a)]

(a) [8:934] **In connection with sale of corporate assets:** Thus, for example, if the corporation's business or assets are sold to a responsible purchaser who *assumes* its liabilities as part of the purchase price, the debts are usually deemed "adequately" provided for. [See *Ray v. Alad Corp.* (1977) 19 C3d 22, 28, 136 CR 574, 578]

1) [8:935] **Compare—liability imposed on successor by operation of law:** Even where the purchaser of a corporation's business or assets does not expressly assume the seller's liabilities, liability may be imposed by operation of law under various statutes and legal theories. *See ¶ 8:639 ff.*

(b) [8:936] **Shareholders' assumption of liability limited to distribution received:** The shareholders may assume liability for the dissolving corporation's debts, but their liability is ordinarily limited to the amount of corporate assets distributed to them upon liquidation. [*Gateway Structures, Inc. v. Carpenters' 46 Northern Calif. Counties Conference Bd. of United Brotherhood of Carpenters & Joiners of America, AFL-CIO* (ND CA 1987) 681 F.Supp. 1437, 1444]

➪ [8:937] ***PRACTICE POINTER:*** If the shareholders have assumed corporate liabilities, any limitation thereon should be *explicitly* stated in the certificate of dissolution (*¶ 8:962*) to avoid any ambiguity about the extent of the shareholders' liability. (E.g., "No shareholder shall have any responsibility for the corporation's liabilities as provided herein in excess of the amount of dividends paid by the corporation to the shareholder from and after _____, 20_____.")

(3) [8:938] **In proceedings subject to court supervision:** When a liquidation proceeding is subject to court supervision, the court may prescribe a time limit within which creditors must present their claims (*see ¶ 8:911*). Creditors who submit their claims will be paid from the corporate assets before they are distributed to the shareholders. Creditors who fail to do so are barred from any share of the corporate assets (see Corps.C. § 1807(a); *¶ 8:915*). They may also be denied recovery against directors for illegal distributions (*see ¶ 8:942*).

Comment: The statute is unclear as to whether such creditors are also barred from asserting their claims against the *shareholders* to whom the corporate assets are distributed (*see ¶ 8:949*); but that apparently is its purpose.

(a) [8:939] **Secured claims:** Holders of secured claims do not lose their secured status by failing to file a claim in the court-supervised dissolution proceedings. But they will be barred from claiming any deficiency above the amount realized on their security. [Corps.C. § 1807(c)]

(b) [8:940] **Claims not matured; contingent claims:** If the creditor's claim is not yet due, the creditor is entitled to its *present value* at the time of distribution. [Corps.C. § 1807(d)]

If the claim is contingent, it is up to the court to make "adequate" provision for its payment from the funds available for distribution. [Corps.C. § 1807(d)]

(c) [8:941] **Disputed claims:** If the corporation disputes the claim, the creditor must file suit *within 30 days* after written notice of its rejection by the corporation. [Corps.C. § 1807(e)]

(4) [8:942] **Director liability to creditors:** It is the responsibility of the directors to pay or make provision for payment of the corporate debts before the corporate assets are distributed to the shareholders (¶ 8:944 ff.). If the directors fail to do so, the corporate distributions will be treated as an *illegal dividend*, and directors approving (or failing to vote against) the distributions may be held personally liable to creditors timely filing claims for the amount of such distributions. [See Corps.C. § 316(a)(2); *see ¶ 7:142*]

(This director liability is in addition to the shareholder liability for receipt of such dividend, ¶ 8:949.)

(5) [8:943] **"Responsible person" liability for unpaid sales taxes:** Upon *dissolution, termination or abandonment* of a corporation, any officer or other person who had control or supervision of, or responsibility for, paying a corporation's sales and use taxes may be personally liable for any unpaid taxes (and interest and penalties) that such person *willfully* (i.e., "intentionally," irrespective of motive) failed to pay during the period that person had such control, supervision or responsibility. (But personal liability attaches only if the corporation included sales tax reimbursement in the selling price of its products.) [Rev. & Tax.C. § 6829; 18 CCR § 1702.5; see *State Bd. of Equalization v. Wirick* (2001) 93 CA4th 411, 415-417, 112 CR2d 919, 922-923—chief financial officer who resigned prior to corporate termination was nonetheless liable for taxes owed during time he was "responsible person"]

g. [8:944] **Distributions to shareholders:** After payment or provision for the corporate debts, the remaining corporate assets are distributed to the shareholders according to their respective rights and preferences. If the winding up is by court

proceedings, such distribution will be made only after expiration of any period of time ordered by the court for presentation of creditors' claims (*see ¶ 8:911*). [Corps.C. § 2004]

(1) [8:945] **Manner of distribution:** Distribution is required to be made as soon as "reasonably consistent with the beneficial liquidation of the corporate assets." The distribution may either be in cash or in property; and it may be either in a lump sum or in installments (if this can be done fairly and ratably and in conformity with the articles of incorporation). [Corps.C. § 2006]

(a) [8:946] **Deposit with State Controller in lieu of payment:** If a shareholder refuses to accept payment, or the shareholder's whereabouts are unknown, or the ownership of the shares is disputed, the corporation may deposit the distribution with the State Controller under the Unclaimed Property Law (CCP § 1500 et seq., *¶ 6:597.5i ff.*). [See Corps.C. § 2008]

(2) [8:947] **Shares with liquidation preference:** Shares having liquidation priority are entitled to be paid first and in *cash*. Often, a different plan of distribution may be proposed (particularly where the assets are being sold for property or securities in lieu of cash). Such a plan is valid if approved by the board of directors and a majority of each class of affected shares. However, preferred shareholders who dissent from the plan and follow specified procedures must be paid in *cash* (in which event, the board may abandon the plan without further shareholder approval). [See Corps.C. § 2007(c), (d)]

(a) [8:948] **Limitation—distributions in reorganization:** But dissenting preferred shareholders have no such rights if the liquidating distribution is made in accordance with a *merger or sale-of-assets reorganization* approved by the same percentage of the class as could amend the articles preference. [Corps.C. § 2007(e)]

(3) [8:949] **Effect of unpaid creditor claims:** If corporate assets are distributed to the shareholders without payment or adequate provision for payment of corporate liabilities, the shareholders may be held personally liable to the extent of the assets received. The distribution is treated, in effect, as a *voidable transaction.* The assets received by them are treated as a "trust fund" for the benefit of the corporate creditors (see Civ.C. §§ 3439.04, 3439.05; Corps.C. §§ 2009, 2011). But shareholders are not liable for predissolution debts beyond the amount distributed to them, even where they "assume the corporation's debts" to enable the corporation to dissolve (¶ 8:936). [*Gateway Structures, Inc. v. Carpenters' 46 Northern Calif. Counties Conference Bd. of United Brotherhood of Carpenters & Joiners of America, AFL-CIO* (ND CA 1987) 681 F.Supp. 1437, 1444]

In addition, the *directors* of the corporation may be held personally liable for distribution of an illegal dividend; *see ¶ 8:942*.

(a) [8:950] **Creditor remedy:** Either the corporation or *any creditor* of the corporation may sue any shareholder or director to recover the amount so distributed. [Corps.C. §§ 2009(a), (b), 2011(a)]

(b) [8:951] **Joinder:** A shareholder sued for recovery of improper distributions from the corporation may make a motion to compel joinder of the other distributee-shareholders as codefendants in the same action. [Corps.C. § 2009(a)]

(c) [8:952] **Contribution:** And, any shareholder held liable for more than the shareholder's ratable share of the improper distribution, has the right to contribution from the other distributee-shareholders. [See Corps.C. § 2009(c)]

[8:953 - 8:960] ***Reserved.***

h. [8:961] **Procedures for completing dissolution:** The procedures required to complete the dissolution depend on whether the liquidation and winding up have been completed under court supervision.

(1) [8:962] **Voluntary dissolutions—certificate of dissolution:** If the corporation's affairs have been wound up without court proceedings (i.e., voluntary dissolutions, *see ¶ 8:752 ff.*), dissolution is completed by filing with the Secretary of State a certificate of dissolution signed and verified by a majority of the directors then in office. [Corps.C. § 1905(a)]

FORM: The Secretary of State's standard form Certificate of Dissolution (DISS STK) is available online at the Secretary of State's website (*www.sos.ca.gov*).

[8:963] ***Reserved.***

(a) [8:964] **Effect of filing:** Upon filing of the certificate of dissolution with the Secretary of State, the corporate powers, rights and privileges cease (except for purposes of winding up, if needed). [Corps.C. § 1905(b); see Corps.C. § 2010, *¶ 8:994*]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1) [8:965] **Certificate irrevocable:** Unlike an *election to wind up and dissolve*, which can be revoked (*see ¶ 8:775 ff.*), the certificate of dissolution *cannot* be revoked after it has been filed. (Reinstatement can be effected only by court order, which may be granted only on limited grounds; *see ¶ 8:997 ff.*) [See *Catalina Investments, Inc. v. Jones* (2002) 98 CA4th 1, 7, 119 CR2d 256, 260 & fn. 5]

2) [8:966] **Limitations period triggered for claims against shareholders:** Filing of the certificate of dissolution starts the clock running on the four-year statute of limitations for creditors to assert postdissolution claims against the shareholders. *See ¶ 8:1010*.

[8:967 - 8:968] ***Reserved.***

(b) [8:969] **Submitting final tax return:** After filing the certificate of dissolution, the Secretary of State notifies the Franchise Tax Board of the dissolution. [Corps.C. § 1905(b)]

As discussed earlier (*¶ 8:917*), the corporation must file a final tax return with the Franchise Tax Board. The Franchise Tax Board will provide the corporation with all additional instructions and forms required to be filed with the Franchise Tax Board and the Secretary of State. [Rev. & Tax.C. § 23335]

1) [8:970] **Avoiding minimum tax after cessation of business:** As a general rule, corporations dissolving or ceasing to do business during a tax year must still pay the *minimum* franchise tax (generally, $800) for that year. [Rev. & Tax.C. § 23153]

However, a corporation is not subject to the minimum franchise tax for a taxable year if the corporation:

- Files a timely final tax return with the Franchise Tax Board for a taxable year (*¶ 8:917*);
- Does no business in California after the end of the taxable year for which the final return was filed; and
- Files the certificate of dissolution (Corps.C. § 1905, *¶ 8:962*) within one year after filing the final tax return. [Rev. & Tax.C. § 23332(c); see *Timberline, Inc. v. Jaisinghani* (1997) 54 CA4th 1361, 1368, 64 CR2d 4, 8 (citing text)]

Further, a corporation that files a certificate of dissolution and thereafter ceases doing business is not subject to the minimum franchise tax for *future* tax years (i.e., those commencing *on or after the date of filing*). [Rev. & Tax.C. § 23153(a)]

[8:971 - 8:980] ***Reserved.***

(2) [8:981] **Voluntary dissolutions—short-form certificate for inactive corporation less than one year old:** A streamlined procedure is available to a corporation that has neither issued shares nor conducted business since its incorporation within the preceding 12 months. Rather than file an election to dissolve and then provide the requisite notice to creditors and other persons (*see ¶ 8:761 ff.*), the corporation may simply file a short-form certificate of dissolution signed and verified by a majority of the directors (or if no directors have been named, by the incorporator or a majority of the incorporators). [Corps.C. § 1900.5(a), (b)]

FORM: The Secretary of State's standard form Short-Form Certificate of Dissolution (DSF STK) is available online at the Secretary of State's website (*www.sos.ca.gov*).

(a) [8:982] **Filing of certificate:** Upon filing the certificate of dissolution by the Secretary of State, the corporation is dissolved and its powers, rights and privileges cease. [Corps.C. § 1900.5(c)]

The Secretary of State will notify the Franchise Tax Board of the dissolution. [Corps.C. § 1900.5(b)]

[8:983 - 8:990] ***Reserved.***

(3) [8:991] **Involuntary dissolutions—court order:** If the liquidation and winding up have been subject to court supervision (involuntary dissolutions, or voluntary dissolutions in which the court has been asked to intervene), the dissolution process is completed by obtaining a court order declaring the corporation wound up and dissolved. [Corps.C. § 1808(a)]

(a) [8:992] **Content of order:** The court's order must state:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- That the corporation has been duly wound up;
- A final franchise tax return, as described by Section 23332 of the Revenue and Taxation Code, has been filed with the Franchise Tax Board as required under Part 10.2 (commencing with Section 18401) of Division 2 of the Revenue and Taxation Code;
- That all its known debts and liabilities have been paid or adequately provided for (and again, in the latter case, detailing the provisions that have been made so as to enable creditors to obtain payment);
- That all known assets have been distributed to the persons entitled thereto;
- That the accounts of directors or such other persons appointed to wind up the corporation's affairs have been settled, and they are discharged from their duties and liabilities to the creditors and shareholders; and
- That the corporation is dissolved. [Corps.C. § 1808(a)]

FORM: Order Declaring Corporation Wound Up and Dissolved, *see Form 8:P*.

(b) [8:993] **Effect of order:** The corporation's existence ceases upon entry of such an order (except for the purpose of further winding up, if necessary). The directors or other persons appointed to liquidate the corporation are discharged from their duties and liabilities in connection therewith. [Corps.C. § 1808(b)]

A copy of the court's order, certified by the clerk, must be filed forthwith with the Secretary of State. [Corps.C. § 1809]

i. [8:994] **Further winding up after dissolution:** Sometimes, corporate acts become necessary after a corporation has been formally dissolved; e.g., where assets or debts belonging to the dissolved corporation are discovered later. To handle such situations, the Code provides that a dissolved corporation *continues to exist* for the purpose of winding up its affairs. This enables the corporation to prosecute and defend actions; to collect and discharge obligations; to dispose and convey property; etc. [Corps.C. § 2010(a); see *Favila v. Katten Muchin Rosenman LLP* (2010) 188 CA4th 189, 212-213, 115 CR3d 274, 292-293; *Timberline, Inc. v. Jaisinghani* (1997) 54 CA4th 1361, 1368-1369, 64 CR2d 4, 8]

(1) [8:995] **Pending litigation:** No action or proceeding to which a corporation is a party abates by reason of its dissolution or winding up; i.e., the action may be continued by or against the corporation notwithstanding its dissolution (e.g., claim against corporation for which it is adequately insured). [Corps.C. § 2010(b)]

(2) [8:996] **Omitted assets:** Any assets inadvertently or otherwise omitted from the winding up continue to belong to the corporation, notwithstanding its dissolution. Upon receipt, such assets are to be distributed to the shareholders or others entitled thereto. [Corps.C. § 2010(c)]

(3) [8:996.1] **Exercise of attorney-client privilege:** Dissolution does not necessarily extinguish any attorney-client privilege held by the corporation prior to dissolution. Because the corporation continues to exist for the purpose of winding up its affairs, “it would appear the persons authorized to act on the dissolved corporation's behalf during the wind-up process—its ongoing management personnel—should be able to assert the privilege, at least until all matters involving the company have been fully resolved and no further proceedings are contemplated.” [*Favila v. Katten Muchin Rosenman LLP* (2010) 188 CA4th 189, 219, 115 CR3d 274, 298; Ev.C. § 953(d); see *Melendrez v. Sup.Ct. (Special Elec. Co., Inc.)* (2013) 215 CA4th 1343, 1353-1354, 156 CR3d 335, 343-344]

(a) [8:996.2] **“Defunct” corporation:** When a corporation no longer exists, the privilege is held by the corporation's “successor, assign, trustee in dissolution, or any similar representative.” [Ev.C. § 953(d)]

- In the situation of a bankrupt corporation having no management personnel or directors, and whose only significant assets consist of one or more liability (third party) *insurance* policies (*see ¶ 8:998*), the *insurer* would be deemed the privilege holder. [*Melendrez v. Sup.Ct. (Special Elec. Co., Inc.)* (2013) 215 CA4th 1343, 1357-1358, 156 CR3d 335, 346-347 (bankrupt corporation existed as “shell” through which personal injury asbestos claims were passed on to its insurer)]

(4) [8:996.3] **Derivative action permitted:** A shareholder of a dissolved corporation may bring a derivative action to prosecute claims on the corporation's behalf; *see ¶ 6:619.5*.

j. [8:997] **Reinstatement of dissolved corporation only upon court order:** Once the certificate of dissolution has been filed, the corporation's powers are limited to acts necessary to wind up its affairs (¶ 8:994). Except as provided below (¶ 8:997.1 ff.), the dissolution cannot be revoked. (A corporation cannot reinstate itself by filing a "certificate of revocation" or similar document.) [See *Catalina Investments, Inc. v. Jones* (2002) 98 CA4th 1, 7, 119 CR2d 256, 260 & fn. 5—corporation that experienced adverse tax consequences upon dissolution could not seek retroactive reinstatement by filing certificate of revocation of dissolution]

(1) [8:997.1] **Procedure:** A court order for reinstatement may be obtained by filing a petition in superior court setting forth the legal and factual basis for reinstatement. Alternatively, the court order may be obtained as part of a civil action for damages or equitable relief. (In either event, the Secretary of State should *not* be named a party.) [Gov.C. § 12261(c); see *Holistic Supplements, L.L.C. v. Stark* (2021) 61 CA5th 530, 556-557, 275 CR3d 791, 809-810—plaintiff did not have to file stand-alone petition for reinstatement because she pled claim for reinstatement in civil action (§ 12261 "does not impose any specific pleading requirements") (*see* ¶ 8:540)]

(2) [8:997.2] **Grounds for reinstatement:** The Secretary of State must reinstate a corporation to active status upon court order finding that (a) the certificate of dissolution contains *materially false representations* or (b) the certificate of dissolution was *fraudulently submitted* to the Secretary of State. [Gov.C. §§ 12260, 12261(a)]

(3) [8:997.3] **Loss of corporate name—amendment of articles to adopt new name:** Once the certificate of dissolution has been filed, the corporation's name (or a similar name) becomes "available" and may be adopted by another corporation. If the Secretary of State determines that the name of the revived corporation would conflict with that of another corporation, reinstatement must be conditioned upon the corporation changing its name (by filing an amendment to its articles) so as to eliminate the conflict. [Gov.C. §§ 12261(b)(2), 12262]

(4) [8:997.4] **Effective date:** Reinstatement is effective upon the Secretary of State's filing of a certified copy of the court order reinstating the corporation. (The Secretary of State will notify the Franchise Tax Board of the reinstatement.) [Gov.C. §§ 12261(b)(3), 12263]

k. [8:998] **Postdissolution lawsuits against corporation:** Dissolution does not impair valid claims against the corporation that have not been paid or provided for in the liquidation proceedings. Claims may be asserted against a dissolved corporation —whether they arise *before or after* dissolution—and the corporation remains liable *to the extent of its undistributed assets*, including any available *insurance*. (Claims exceeding the corporation's undistributed assets may be enforced against the shareholders to the extent they receive liquidation distributions; *see ¶ 8:1008 ff.*) [Corps.C. §§ 2010(a), 2011(a); see *Penasquitos, Inc. v. Sup.Ct. (Barbee)* (1991) 53 C3d 1180, 1193-1194, 283 CR 135, 143; see also *Melendrez v. Sup.Ct. (Special Elec. Co., Inc.)* (2013) 215 CA4th 1343, 1357-1358, 156 CR3d 335, 346-347 (*discussed at ¶ 8:996.2*); *Westoil Terminals Co. v. Harbor Ins. Co.* (1999) 73 CA4th 634, 642, 86 CR2d 636, 641]

The power of a dissolved corporation to defend (and *prosecute*) claims continues to the extent necessary to wind up its affairs. [Corps.C. § 2010(a); see *Favila v. Katten Muchin Rosenman LLP* (2010) 188 CA4th 189, 212-217, 115 CR3d 274, 292-296; *Westoil Terminals Co. v. Harbor Ins. Co.*, supra; see also *Melendrez v. Sup.Ct. (Special Elec. Co., Inc.)*, supra]

(1) [8:999] **Compare—California law not applicable to foreign corporation:** Corps.C. § 2010(a), which sets no time limit on suits against a dissolved corporation for injuries arising from predissolution activities, does *not* apply to foreign corporations. Dissolution provisions are not among the statutory provisions made applicable to foreign corporations by Corps.C. § 2115 (¶ *3:5 ff.*). Thus, the effect of a foreign corporation's dissolution on claims against the corporation is determined by the laws of its *state of incorporation*. [*Greb v. Diamond Int'l Corp.* (2013) 56 C4th 243, 258-262, 153 CR3d 198, 209-212—Delaware statute barring actions filed more than 3 years after corporation's dissolution applied to personal injury action against dissolved Delaware corporation that did business in California]

[8:1000 - 8:1005] ***Reserved.***

(2) [8:1006] **Quiet title actions:** Dissolution of a corporate defendant has no effect on a plaintiff's right to maintain a quiet title action. A dissolved corporation is deemed to survive and continue to exist *indefinitely* for the purpose of being sued in any quiet title action. And, any judgment rendered in the quiet title action against the corporation is binding on shareholders or others having any interest in the corporation. [Corps.C. § 2011(c)]

(3) [8:1007] **Service of process:** Summons can be served on any officer or director of the dissolved corporation having charge of its assets; or if none, upon any agent for service of process at the time of dissolution. [Corps.C. § 2011(b)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

If no such persons can be found, a court may authorize service upon the Secretary of State. [Corps.C. § 2011(b)]

(a) [8:1007.1] **No relief from default where agent served:** Where post-dissolution process was served upon the person who was the corporation's duly designated agent at the time of dissolution, the corporation is deemed to have "actual notice" of the lawsuit and thus may not obtain relief under CCP § 473.5(a) from a subsequent default judgment. [*Pulte Homes Corp. v. Williams Mechanical, Inc.* (2016) 2 CA5th 267, 273-275, 206 CR3d 244, 249-250; see CCP § 473.5(a)—relief from default may be granted "[w]here service of a summons has *not* resulted in *actual notice* to a party in time to defend the action …" (emphasis added)]

Service upon such an agent also precludes relief from default on equitable grounds ("extrinsic mistake") where the agent fails to notify the dissolved corporation's former officers or directors of the lawsuit. [*Pulte Homes Corp. v. Williams Mechanical, Inc.*, supra, 2 CA5th at 276-277, 206 CR3d at 251-252]

l. [8:1008] **Shareholder liability following dissolution:** Shareholders receiving assets of a dissolved corporation may be liable for corporate obligations, whether arising before or after dissolution. However, the shareholders' liability is limited to the amount of the assets distributed to them or their pro rata share of the claim, whichever is less. In no event may a shareholder's total postdissolution liability exceed the total amount of assets distributed to the shareholder, regardless of the number of claims. [Corps.C. § 2011(a)(1)]

• [8:1009] **Comment:** Corps.C. § 2011(a)(1) codifies the "equitable trust fund" theory (*see ¶ 8:949*), under which assets distributed in dissolution are deemed held by the shareholders "in trust" for the benefit of all the dissolved corporation's creditors—even those whose claims arose after dissolution. [Cf. *Pacific Scene, Inc. v. Penasquitos, Inc.* (1988) 46 C3d 407, 411-414, 250 CR 651, 653-655—prior statutes supplanted common law trust fund theory for asserting postdissolution claims against shareholders]

(1) [8:1010] **Maximum four-year statute of limitations:** All causes of action against a dissolved corporation's shareholders (excepting quiet title actions, *¶ 8:1006*) are extinguished *unless* suit is brought before expiration of the statute of limitations applicable to the particular cause of action, and in any event within *four years* of the effective date of the corporation's dissolution (i.e., when the certificate of dissolution is filed with the Secretary of State; *see ¶ 8:964 ff.*). [Corps.C. § 2011(a)(2)]

(2) [8:1011] **Shareholders sued in corporate name:** As a strictly procedural matter, a dissolved corporation's shareholders may be sued *in the corporate name* on any cause of action against the corporation. However, this statute is procedural, and does not purport to determine whether the shareholders are legally responsible for the corporation's debts. [Corps.C. § 2011(a)(3)]

(a) [8:1012] **Unpaid creditor claims:** Such liability might be based upon distribution of corporate assets without adequate provision for payment of corporate liabilities—treated as a *voidable transaction*; *see* ¶ 8:949.

(b) [8:1013] **Quiet title actions:** Further, any judgment rendered in a quiet title action against the corporation (*¶ 8:1006*) also binds the shareholders to whom any of the corporate property has been distributed. [Corps.C. § 2011(c)]

[8:1014 - 8:1040] ***Reserved.***

6. [8:1041] **Duty to Employees in Effecting Layoffs and Plant Closings:** Both federal and state law require that employees receive advance notice of a plant closing or mass layoff. These notice requirements may be triggered when a corporate employer is dissolved and liquidated; and also incident to corporate acquisitions, reorganizations and asset sales that adversely affect employees.

Cross-refer: The applicable law is overviewed below (¶ 8:1042 ff.). For a more comprehensive treatment of state and federal law governing layoffs and plant closings, see Chin, Wiseman, Callahan & Lowe, *Cal. Prac. Guide: Employment Litigation* (TRG), Ch. 6.

a. [8:1042] **Federal WARN Act:** The federal Worker Adjustment and Retraining Notification Act (WARN Act, 29 USC §§ 2101-2109) requires certain employers to give employees 60 days' advance notice of a "*plant closing*" or "*mass layoff*."

(1) [8:1043] **Employers subject to WARN Act:** The WARN Act applies to "any business enterprise" that employs:

• *100 or more full-time employees* (i.e., employees who work an average of 20 or more hours per week and who worked at least six months in the preceding 12 months); or

• 100 or more full-time or part-time employees who work at least 4,000 hours per week in the aggregate (excluding overtime). [29 USC § 2101(a)(1) & (8)]

(a) [8:1043.1] **Separate corporations as "single employer":** *See* *¶ 2:52.13 ff.*

(b) [8:1044] **Compare—fiduciary liquidating bankrupt business:** A trustee in bankruptcy, secured creditor or debtor-in-possession whose sole purpose is to preserve the assets of a business for liquidation or sale is *not* operating a "business enterprise" in the normal commercial sense, and hence does *not* succeed to the former employer's WARN Act notice obligations. (But if the fiduciary *continues to operate* the business, the WARN Act will apply.) [54 Fed.Reg. 16045 (1989); *In re United Healthcare System, Inc.* (3rd Cir. 1999) 200 F3d 170, 177-179 & fn. 9; *Chauffeurs, Sales Drivers, Warehousemen & Helpers Union Local 572, Int'l Brotherhood of Teamsters, AFL-CIO v. Weslock Corp.* (9th Cir. 1995) 66 F3d 241, 244]

(2) [8:1045] **When advance notice required:** Employers subject to the Act must give at least 60 days' advance notice before a "plant closing" or "mass layoff."

(a) [8:1046] **"Plant closing":** A "plant closing" means the temporary or permanent closing of a "*single site of employment*" (¶ 8:1046.1), or one or more facilities or "operating units" within a site of employment, resulting in an "*employment loss*" (*¶ 8:1048*) for *50 or more full-time employees* during any 30-day period. [29 USC § 2101(a)(2); see *Sides v. Macon County Greyhound Park, Inc.* (11th Cir. 2013) 725 F3d 1276, 1281; *United Mine Workers of America v. Martinka Coal Co.* (4th Cir. 2000) 202 F3d 717, 722-723—workers laid off before plant closing date entitled to 60 days' advance notice of *layoff* where layoff *causally related* to closing]

1) [8:1046.1] **"Single site of employment":** A "single site of employment" may comprise:

— A group of contiguous structures forming a *campus or industrial park*;

— Separate facilities *across the street* from one another; or

— Separate buildings in *reasonable geographic proximity* that are used for the *same purpose* and share the *same staff and equipment*. [20 CFR § 639.3(i)(1), (3)]

But *noncontiguous* sites in the same geographic area that do *not* share the same staff or operational purpose (e.g., assembly plants located on opposite sides of town and employing different workers), or contiguous buildings that have *separate management and workforces* and produce *different products*, are *not* a "single site of employment." [20 CFR § 639.3(i)(4), (5); see *Davis v. Signal Int'l Texas GP, L.L.C.* (5th Cir. 2013) 728 F3d 482, 485—"single site of employment" determination presents mixed question of law and fact]

a) [8:1046.2] **Mobile and "outstationed" workers:** For workers whose primary duties require *travel* from point to point, who are "*outstationed*" (i.e., living for a short period of time at a certain site), or whose primary duties involve work *outside any of the employer's regular employment sites* (e.g., railroad workers, bus drivers, salespersons), the "single site of employment" is the site:

— To which they are assigned as their home base;

— From which their work is assigned; or

— To which they report. [20 CFR § 639.3(i)(6); see *Bader v. Northern Line Layers, Inc.* (9th Cir. 2007) 503 F3d 813, 818-822—headquarters of construction company that employed workers scattered throughout U.S. in largely autonomous work sites was not "single site of employment"]

(b) [8:1047] **"Mass layoff":** A "mass layoff" is a reduction in force resulting in an "employment loss" (¶ 8:1048) at a single site of employment during any 30-day period for at least (i) 33% of the full-time employees, but not fewer than 50 full-time employees; or (ii) 500 full-time employees, regardless of the percentage of employees affected. [29 USC § 2101(a)(3); see *Sides v. Macon County Greyhound Park, Inc.* (11th Cir. 2013) 725 F3d 1276, 1281; *Ellis v. DHL Express Inc. (USA)* (7th Cir. 2011) 633 F3d 522, 525-526]

(c) [8:1048] **"Employment loss":** An "employment loss" is:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

— An employment termination, other than a discharge for cause, voluntary departure (*see* ¶ *8:1048.1*) or retirement; or

— An over six-month layoff; or

— A more than 50% reduction in work hours during each month of any six-month period. [29 USC § 2101(a)(6); see *International Alliance of Theatrical & Stage Employees & Moving Picture Machine Operators, AFL-CIO v. Compact Video Services, Inc.* (9th Cir. 1995) 50 F3d 1464, 1468-1469—pay/benefits cut not an "employment loss"; and *Graphic Communications Int'l Union, Local 31-N v. Quebecor Printing (USA) Corp.* (4th Cir. 2001) 252 F3d 296, 298-300]

1) [8:1048.1] **Voluntary departure:** Employees who depart for the *express reason that the business is closing* do *not* depart voluntarily. Thus, these employees must be *included* in determining the "employment loss" triggering the requisite 60-day notice. [*Collins v. Gee West Seattle LLC* (9th Cir. 2011) 631 F3d 1001, 1006-1008 & fn. 4—employees who were given only 10 days' notice of plant closing and who reacted thereto by departing before closing did not depart voluntarily; compare *Ellis v. DHL Express Inc. (USA)* (7th Cir. 2011) 633 F3d 522, 525-527—employees who accepted union-negotiated severance agreements departed voluntarily]

(d) [8:1049] **Exceptions:** There are some exceptions to the WARN Act's notice requirements:

1) [8:1049.1] **Employees hired by purchaser of business:** A sale of the business may result in a technical termination of its employees. But where the purchaser hires (or offers to hire) the employees, there is no actual employment loss and hence no obligation to provide a WARN notice. [See 29 USC § 2101(b); 20 CFR § 639.6; *Wilson v. Airtherm Products, Inc.* (8th Cir. 2006) 436 F3d 906, 909-912; *International Alliance of Theatrical & Stage Employees & Moving Picture Machine Operators, AFL-CIO v. Compact Video Services, Inc.* (9th Cir. 1995) 50 F3d 1464, 1468, fn. 2; compare *Phason v. Meredian Rail Corp.* (7th Cir. 2007) 479 F3d 527, 529-530—"sale exception" not applicable where 8 calendar days elapsed from time employer closed plant to time sale was consummated and purchaser hired employees (employment loss occurred)]

The "sale exception" applies whether the purchaser acquires the corporation or only its assets. [*International Alliance of Theatrical & Stage Employees & Moving Picture Machine Operators, AFL-CIO v. Compact Video Services, Inc.*, supra, 50 F3d at 1467; see *Patterson v. O'Neal* (ND CA 2009) 673 F.Supp.2d 974, 981-982—factual issue whether voluntary transfer of portion of law firm's attorneys and staff to another firm constituted "sale" (*discussed further at* ¶ *8:1070*)]

2) [8:1050] **Employees offered a transfer:** No notice need be given if the closing or layoff is due to the relocation or consolidation of all or part of the employer's business and, *prior* to the closing or layoff, the employer offers to *transfer* the employee to:

- A different employment site within a reasonable commuting distance with no more than a six-month break in employment; or

- *Any other* employment site (regardless of distance) with no more than a six-month break in employment, and the employee accepts within 30 days of the offer or the closing or layoff, whichever is later. [29 USC § 2101(b)(2)]

3) [8:1051] **Natural disasters:** Advance notice is not required if the plant closing or mass layoff is due to a natural disaster—e.g., flood, earthquake or drought. [29 USC § 2102(b)(2)(B)]

4) [8:1052] **Closing of temporary facility; temporary employees:** Nor does the WARN Act apply to the closing of a "temporary facility"; or a closing or layoff due to completion of a "particular project or undertaking" where the affected employees were hired with the understanding that their employment was limited to the duration of the facility or undertaking. [29 USC § 2103]

5) [8:1053] **Government-ordered shutdowns:** The Act does *not* apply where a governmental authority orders an employer to shut down operations or takes over the employer's business. [*Deveraturda v. Globe Aviation Security Services* (9th Cir. 2006) 454 F3d 1043, 1046-1049—company that provided airport security screening not liable under WARN Act when federal government took over airport security nationwide by act of Congress; see *Buck v. Federal Deposit Ins. Corp.* (8th Cir. 1996) 75 F3d 1285, 1290-1291—no WARN Act liability where FDIC took over failed bank]

An employer's plant closing or mass layoff caused indirectly by governmental action, such as loss of a contract, is treated as an "unforeseen business circumstance"; *¶ 8:1063*.

6) [8:1054] **Strikes or lockouts:** Finally, the Act does not apply if the closing or layoff is caused by a bona fide strike or lockout. [29 USC § 2103]

[8:1055 - 8:1060] ***Reserved.***

(3) Notice requirements

(a) [8:1061] **60 days' notice normally required:** Employers subject to the Act must ordinarily give at least *60 days' advance notice* before ordering a plant closing or mass layoff (¶ 8:1045 ff.). [29 USC § 2102(a); see *Marques v. Telles Ranch, Inc.* (9th Cir. 1997) 131 F3d 1331, 1334—seasonal workers laid off every November through April received adequate WARN notice when told in November they would not be rehired in April]

(b) [8:1062] **Reduction in notice period:** However, employers need only give as much notice as is *practicable* (i.e., less than 60 days) where:

1) [8:1063] **Unforeseen business circumstances:** At the time 60 days' notice would have been required, the plant closing or mass layoff is caused by business circumstances that were *not "reasonably foreseeable"*—i.e., some *sudden, dramatic and unexpected* action or condition *outside the employer's control*. [29 USC § 2102(b)(2)(A) & (3) (emphasis added); 20 CFR § 639.9(b)(1); see *Childress v. Darby Lumber, Inc.* (9th Cir. 2004) 357 F3d 1000, 1008; *United Steel Workers of America Local 2660 v. United States Steel Corp.* (8th Cir. 2012) 683 F3d 882, 886-889 (employer closed one of its plants after major, unanticipated economic downturn caused sales to go into "free fall"); *Halkias v. General Dynamics Corp.* (5th Cir. 1998) 137 F3d 333, 335-336 (Defense Department cancellation of contract caused employer to effect "mass layoff")]

2) [8:1064] **COVID-19 pandemic and business shutdowns:** It is unclear whether employers were excused from giving the 60 days' notice required under the WARN Act to employees who have been furloughed or terminated because of the COVID-19 pandemic and the government shutdown orders that followed.

Cross-refer: For a discussion of the notice requirements under California's state law counterpart to the WARN Act (Lab.C. § 1400 et seq.) during the COVID-19 pandemic, *see* ¶ 8:1099.1.

a) [8:1064.1] **Labor Department guidance:** The U.S. Department of Labor issued guidance to employers for complying with the WARN Act during the COVID-19 pandemic. [See Labor Dept., "Worker Adjustment and Retraining Notification Act Frequently Asked Questions," available at *www.dol.gov/agencies/eta/layoffs/warn*]

Caution: The Labor Department's guidance acknowledges that it does "not have the force and effect of law," is "not meant to bind the public in any way," and "is intended only to provide clarity to the public regarding existing requirements under the law or agency policies." [Labor Dept., "Worker Adjustment and Retraining Notification Act Frequently Asked Questions," available at *www.dol.gov/agencies/eta/layoffs/warn*]

In its guidance on complying with the WARN Act during the COVID-19 pandemic, the Labor Department highlighted the following WARN Act regulations:

- When a short-term layoff (six months or less) is extended to last longer than originally contemplated, the layoff is treated for covered employers as an "employment loss" from the date the layoff started and may violate the WARN Act unless (i) the extension beyond six months is caused by business circumstances not reasonably foreseeable at the time of the initial layoff, and (ii) notice is given by the employer at the time it becomes reasonably foreseeable that an extension beyond six months will be required. [See 20 CFR § 639.4(b)]

- The unforeseeable business circumstances exception to the required notice for plant closings and mass layoffs is generally caused by some sudden, dramatic, and unexpected action or condition outside the employer's control such as unanticipated and dramatic major economic downturn that was not reasonably foreseeable. A government-ordered closing of an employment site that occurs without prior notice also may be an unforeseeable business circumstance. [See 20 CFR § 639.9(b)(1)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• The test for determining when business circumstances are not reasonably foreseeable focuses on an employer's business judgment—the employer must exercise the commercially reasonable business judgment that a similarly situated employer would exercise in predicting the demands of its particular market; the employer is not required to accurately predict general economic conditions that also may affect demand for its products or services. [See 20 CFR § 639.9(b)(2)]

• When invoking an exception to the WARN Act's 60-day notice requirement, covered employers are still required to give as much notice as is practicable, and to include a brief statement of the reason for giving less than 60-days' notice along with the other required elements of a WARN Act notice. [See 20 CFR § 639.9]

b) [8:1064.2] **COVID-19 pandemic-related litigation:** Whether employers could rely on any exception from the WARN Act's notice requirements when furloughing and laying off employees in response to the COVID-19 pandemic and ensuing government shutdown orders is currently the subject of pending litigation. [See, e.g., *Easom v. US Well Services, Inc.* (5th Cir. 2022) 37 F4th 238, 244 (reversing denial of plaintiffs' motions for summary judgment and reconsideration and remanding for further proceedings)—COVID-19 did not qualify as natural disaster under WARN Act's natural disaster exception to notice requirement]

3) [8:1065] **Faltering company:** Or, the employer is actively seeking new capital or business when notice should be given, and *reasonably believes in good faith* that giving 60 days' notice would prevent it from obtaining the new capital or business (e.g., notice might induce employees or customers to leave). [29 USC § 2102(b)(1) & (3); see *Childress v. Darby Lumber, Inc.* (9th Cir. 2004) 357 F3d 1000, 1009; *Alarcon v. Keller Indus., Inc.* (9th Cir. 1994) 27 F3d 386, 390-391; also see *Collins v. Gee West Seattle LLC* (9th Cir. 2011) 631 F3d 1001, 1007-1008]

(c) [8:1066] **Contents of notice:** The notice must be:

— *in writing;*

— *specific* as to separation date and reason for termination; and

— based on the *best information available* to the employer at the time the notice is served. [20 CFR § 639.7(a)]

(d) [8:1067] **Procedure:** The notice must be sent to the employees' union or, if there is no union, to each affected employee. The California Employment Development Department and the head of the local government (e.g., city or county) must also be notified. [29 USC § 2102(a)]

(e) [8:1068] **Responsibility for providing notice upon sale of "business":** Where all or part of a covered employer's "business" is sold (*see ¶ 8:1071*), the *seller* is responsible for providing notice under the WARN Act for any plant closing or mass layoff *up to and including the effective date of the sale*. The *purchaser* must provide the required notice for any closings or layoffs *after* the effective date of sale. [29 USC § 2101(b)(1)]

1) [8:1069] **Sale itself *not a WARN Act event:*** A sale that does not result in a "plant closing" (*¶ 8:1046*) or "mass layoff" (*¶ 8:1047*) does not trigger the 60 days' WARN Act notice requirement. Although a technical termination may occur when the seller discharges and the buyer rehires the seller's employees, WARN Act notice is required only where the employees experience an actual "employment loss" (*¶ 8:1048*). If the business continues as before with no significant changes, there is no need to go through the WARN Act notification process. [20 CFR § 639.6; *International Alliance of Theatrical & Stage Employees & Moving Picture Machine Operators, AFL-CIO v. Compact Video Services, Inc.* (9th Cir. 1995) 50 F3d 1464, 1467-1468]

2) [8:1070] **"Piecemeal" sales—no purchaser duty to remaining employees where business continues:** Sometimes, a "plant closing" or "mass layoff" results only after successive sales of portions of the business. Where the business continues for an indefinite time following partial sales, the purchasers have no obligation to the employees who *remained with the business* to provide WARN Act notice to them prior to the business' subsequent demise. "A decision not to hire employees who do not face imminent and certain loss of employment is not tantamount to an order of a plant closing or mass layoff." [*Patterson v. O'Neal* (ND CA 2009) 673 F.Supp.2d 974, 983-984]

3) [8:1071] **Compare—asset sales:** When only *assets* are sold, the *seller* retains the WARN Act notice requirement … because the seller is the party actually closing the plant that results in employment loss. On the other hand, when the sale is of the *business as a going concern* and the seller still employs its employees on the day of the sale, the *buyer*

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

is *presumed* to be the employer for WARN Act purposes. Whether a sale is of assets or of the "business" is a factual issue determined based on all the circumstances; the parties' characterization of the transaction is not controlling. [*Day v. Celadon Trucking Services, Inc.* (8th Cir. 2016) 827 F3d 817, 826-830 (finding "Asset Purchase Agreement" actually effected sale of business as going concern)]

➪ [8:1072] ***PRACTICE POINTER:*** The *sale agreement* should set forth which party is responsible for giving a WARN notice (if required), and should fix liability for failure to do so. [See 20 CFR § 639.4(c)(2)]

[8:1073 - 8:1075] ***Reserved.***

(4) Employer liability for noncompliance

(a) [8:1076] **Employees' backpay and benefits:** Employers violating the WARN Act are liable for all affected employees' backpay and benefits for each day the employees would have worked during the period in which the employer was required but failed to give the notice. "Benefits" include "the cost of *medical expenses* incurred during the employment loss which would have been covered under an employee benefit plan if the employment loss had not occurred." [29 USC § 2104(a)(1) & (2) (emphasis added); *Local Joint Executive Bd. of Culinary/Bartender Trust Fund v. Las Vegas Sands, Inc.* (9th Cir. 2001) 244 F3d 1152, 1159—backpay liability includes provable tips; *Burns v. Stone Forest Indus., Inc.* (9th Cir. 1998) 147 F3d 1182, 1184-1185]

1) [8:1077] **Trade union as plaintiff:** The employees' union has standing to bring a WARN Act suit on behalf of its aggrieved members. [29 USC § 2104(a)(5); *United Food & Comm'l Workers Union Local 751 v. Brown Group, Inc.* (1996) 517 US 544, 551-558, 116 S.Ct. 1529, 1533-1537]

2) [8:1078] **Limitations period for damages actions:** The WARN Act contains no statute of limitations; consequently, courts must apply the *most closely analogous* state statute of limitations. [*North Star Steel Co. v. Thomas* (1995) 515 US 29, 33-35, 115 S.Ct. 1927, 1930-1931]

(b) [8:1079] **Civil penalty to local government:** In addition, an employer who fails to give the required notice to the local government unit is subject to a maximum $500 civil penalty for each day of noncompliance. But this penalty does not apply if the employer pays the amount due to each aggrieved employee within three weeks after the shutdown or layoff. [29 USC § 2104(a)(3)]

(c) [8:1080] **Employer's "good faith" as mitigating factor:** The WARN Act liabilities and penalties may be *reduced* in the court's discretion if the employer proves it made a "good faith" effort to comply with the WARN Act and had reasonable grounds for its actions. [29 USC § 2104(a)(4); see *Childress v. Darby Lumber, Inc*. (9th Cir. 2004) 357 F3d 1000, 1007; *Day v. Celadon Trucking Services, Inc.* (8th Cir. 2016) 827 F3d 817, 835-836]

[8:1081 - 8:1090] ***Reserved.***

b. [8:1091] **California law:** California Lab.C. § 1400 et seq. was enacted in 2002 as a counterpart to the federal WARN Act. It parallels most of the WARN Act provisions but there are some significant differences noted below (¶ 8:1092 ff.).

(1) [8:1092] **Employers subject to California Act:** The California statute applies to any person or business entity that owns and operates a "covered establishment," which is "any industrial or commercial facility" that employs (or within the past 12 months has employed) *at least 75 persons.* [Lab.C. § 1400(a), (b)]

(a) [8:1093] **Subsidiaries:** A parent corporation is an "employer" as to any covered establishment owned and operated by its subsidiary. [Lab.C. § 1400(b)]

(b) [8:1094] **Determining number of employees:** All persons employed for *at least six months* during the previous 12-month period are counted. [Lab.C. § 1400(h)]

Effect: This appears to *include part-time* as well as full-time employees; but it *excludes new hires* (those employed less than six months).

1) [8:1095] **Not seasonal employees:** The California statute expressly does not apply to persons employed in seasonal employment with the *understanding* that the employment was seasonal and temporary. [Lab.C. § 1400(g)(2)]

Comment: If the matter is disputed, it may be up to the employer to *prove* the employee understood the employment was temporary.

(c) [8:1096] **Compare—WARN Act:** The WARN Act is limited to employers with at least 100 employees, excluding part-time workers and new hires (or at least 100 employees who in the aggregate work at least 4,000 hours per week excluding overtime). *See ¶ 8:1043*.

(2) [8:1097] **Notice requirement—in general:** Like the WARN Act, the California statute generally requires covered employers to provide at least 60 days' prior notice of a "mass layoff, relocation or termination" of a "covered establishment" (*see ¶ 8:1092*) to (a) all affected employees and (b) designated governmental officials (the Employment Development Department, "local workforce investment board," and chief elected official of each city and county government involved). [Lab.C. § 1401(a)]

(a) [8:1098] **Exceptions—disasters:** Notice is excused where the layoff, relocation or termination is necessitated by a "*physical calamity* or *act of war*." [Lab.C. § 1401(c) (emphasis added)]

(b) [8:1099] **Exception—faltering company:** Notice of a relocation or termination (but *not* a mass layoff) is excused where the employer furnishes records and affidavits and the *Employment Development Department determines* that:

- At the time notice was required, the employer was actively seeking capital or business that would have enabled it to avoid or postpone the relocation or termination; and

- The employer reasonably and in good faith believed that *giving the 60 days' notice would preclude it from obtaining the needed capital or business*. [Lab.C. § 1402.5]

(c) [8:1099.1] **Suspension during COVID-19 pandemic:** In response to the COVID-19 pandemic, the Governor of California issued an executive order suspending Lab.C. §§ 1401(a), 1402 and 1403. The suspension began on March 4, 2020, and expired on June 30, 2021. [Exec. Order N-31-20 (Mar. 17, 2020) & Exec. Order N-08-21 (June 11, 2021), available at *www.gov.ca.gov*]

(3) [8:1100] **Covered events:** Notice is required prior to any "mass layoff," "relocation" or "termination" at a covered establishment. [Lab.C. § 1401(a)]

(a) [8:1101] **"Mass layoff":** A "mass layoff" occurs when *at least 50 employees* are separated from their positions within any 30-day period due to lack of funds or work. [Lab.C. § 1400(c), (d); see *MacIsaac v. Waste Mgmt. Collection & Recycling, Inc.* (2005) 134 CA4th 1076, 1084-1087, 36 CR3d 650, 657-659—transfer of employees from one employer to another as part of sale of business not a layoff where employees experienced no palpable employment changes]

1) [8:1102] **Length of layoff?** The California statute does not state how long the employees must be off the job to constitute a "layoff." Thus, notice may be required even where the employer plans to and does *rehire* the affected employees within a few weeks or months. [See *International Brotherhood of Boilermakers, Iron Ship Builders, Blacksmiths, Forgers and Helpers, Local 1998 v. NASSCO Holdings, Inc.* (2017) 17 CA5th 1105, 1118, 1122-1128, 226 CR3d 206, 213, 216-221—California statute applied to layoffs lasting approximately 5 weeks]

2) [8:1103] **Compare—WARN Act:** The WARN Act applies only to employment losses during a 30-day period affecting *500 employees* (or one-third of full-time employees at a single worksite involving at least 50 employees) and lasting *at least six months. See ¶ 8:1047*.

(b) [8:1104] **"Relocation":** "Relocation" means removal of "all or substantially all" of the employer's industrial or commercial operations at a covered establishment to a different location *at least 100 miles away.* [Lab.C. § 1400(e)]

Comment: Note that "relocation" is *not conditioned on employment loss*. The employer therefore apparently must give the requisite notice (or incur liability for failure to do so, *see ¶ 8:1117*) even if the employer offers continued employment at the new worksite and the employee *accepts* the offer.

1) [8:1105] **Compare—WARN Act:** The WARN Act *exempts* relocations to a different worksite "within a reasonable commuting distance" with no more than a six-month break in employment. *See ¶ 8:1050*.

(c) [8:1106] **"Termination":** "Termination" means the cessation or substantial cessation of industrial or commercial operations in a covered establishment. [Lab.C. § 1400(f)]

Comment: Again, "termination" is *not conditioned on employment loss*. Reading the statute literally, one could argue that notice is required even when a going business is sold to a new owner who retains all the existing employees. However, such a result is anomalous and appears contrary to legislative intent. [See *MacIsaac v. Waste Mgmt. Collection & Recycling, Inc.* (2005) 134 CA4th 1076, 1089-1092, 36 CR3d 650, 661-663 & fn. 11; *and ¶ 8:1101*]

1) [8:1107] **Compare—WARN Act:** The WARN Act excludes terminations resulting from the employer's sale of the business where the buyer retains existing employees in their jobs after the sale. *See ¶ 8:1069*.

(d) [8:1108] **Limitation—exempt closings and layoffs:** The California statute does not apply to layoffs of seasonal employees (*see ¶ 8:1095*) or resulting from completion of a particular project or undertaking in certain industries (e.g., construction, broadcasting) covered by Industrial Welfare Commission wage orders … *provided* the affected employees were hired with the understanding that their employment was limited to the duration of that project. [Lab.C. § 1400(g)(1)]

[8:1109 - 8:1115] ***Reserved.***

(4) [8:1116] **Content of notice:** The California statute incorporates the WARN Act's notice requirements; i.e., the 60-day notice must be:

— in writing;

— specific as to separation date and reason for the layoff, relocation or termination; and

— based on the best information then available to the employer. [Lab.C. § 1401(b); *see ¶ 8:1066*]

(5) [8:1117] **Civil liability for failure to provide notice:** An employer who fails to give the requisite notice before ordering a mass layoff, relocation or termination is liable to each affected employee for:

• *Back pay* at the average regular rate of compensation received by the employee during the last three years of the employee's employment, or the employee's final rate of pay, whichever is *higher;* and

• *Lost benefits* to which the employee would have been entitled had the employee's employment continued, including any *medical expenses incurred* by the employee that would have been covered under an employee benefit plan. [Lab.C. § 1402(a)(1) & (2)]

(a) [8:1118] **60-day maximum:** The employer's liability for pay and benefits is limited to a maximum of 60 days (or one-half the number of days the employee was employed, if less). [Lab.C. § 1402(b)]

(b) [8:1119] **Set-offs:** The employer's liability is reduced by:

• *Wages paid* to the employee during the period of the violation, except vacation money accrued before the violation;

• Payments to a third party or trustee for *employee benefits* during the period of the violation (e.g., premiums for health benefits or to a defined contribution pension plan); and

• Any *voluntary and unconditional payments* by the employer to the employee that were not required to satisfy any legal obligation. [Lab.C. § 1402(c)]

[8:1120 - 8:1125] ***Reserved.***

(c) [8:1126] **Enforcement:** Any affected employee, or any government or employee representative, may bring a civil action to enforce the employer's liability on behalf of the employee, other persons similarly situated, or both. [Lab.C. § 1404]

1) [8:1127] **Attorney fees:** The court may award reasonable attorney fees, as part of costs, to a prevailing *plaintiff*. [Lab.C. § 1404]

(6) [8:1128] **Civil penalty:** An employer who fails to give the requisite notice is also subject to a "civil penalty" of not more than $500 for each day of the violation (no matter how many employees are involved). [Lab.C. § 1403]

Comment: The penalty is presumably payable to the State and may be imposed as an additional remedy in a civil action by affected employees or in enforcement proceedings instituted by the Labor Commissioner.

(a) [8:1129] **Avoidance:** The employer can avoid this civil penalty by paying *all* affected employees the back pay and lost benefits due them under § 1402 (*¶ 8:1117*) within three weeks after ordering the mass layoff, relocation or termination. [Lab.C. § 1403]

(b) [8:1130] **Reduction:** The court may reduce the amount of the penalty if it determines that an employer conducted "a reasonable investigation in good faith." [Lab.C. § 1405]

[8:1131 - 8:1150] ***Reserved.***

7. [8:1151] **Tax Effects of Dissolution:** Dissolution ordinarily has tax consequences to *both* the corporation and its shareholders. Generally, gain or loss is recognized by the *corporation* on any liquidating *sale* of its assets, and also on the liquidating *distribution* of its remaining assets to its shareholders (*¶ 8:1176*). In addition, the *shareholders* recognize gain or loss on receiving such distributions. *The result is "double" taxation of such corporate distributions*.

a. [8:1152] **Tax consequences to shareholders:** The shareholders generally recognize *capital* gain or loss on distributions they receive on dissolution of a corporation. The money or property they receive is treated as being in "exchange" for their shares. Thus, they recover their cost or tax basis tax-free. Gain is recognized only to the extent the money or value of property received exceeds the shareholders' basis in their stock; and, conversely, loss is recognized to the extent the distribution is less than the shareholders' basis. [IRC § 331(a)]

[8:1153 - 8:1154] ***Reserved.***

(1) [8:1155] **Requirement of complete liquidation:** Capital gains treatment is available for distributions received in *complete* liquidation of the corporation—as opposed to stock redemptions and other "partial" liquidations of a shareholder's interest, which *may* or may not qualify for capital gains treatment. [IRC § 331(a); *see ¶ 7:228 ff.*]

(2) [8:1156] **When gain or loss recognized:** If gain is recognized on liquidation of a corporation, the full amount will normally be taxed in the year in which the liquidation distribution is received. Thus, the *installment* method of reporting income normally *cannot* be utilized.

(a) [8:1157] **Comment:** This puts the shareholders at a distinct disadvantage: Had they sold their shares to an outsider (rather than exchanged them for the assets of the corporation), they could have used the installment method of reporting the gain to defer the tax (see IRC § 453).

(b) [8:1158] **Deferral or shifting of gain through sale of shares on installments:** A shareholder may attempt to shift or defer the capital gain tax by selling the shareholder's shares to children or a trust for their benefit, and having them agree to pay for same in installments over a period of years. The children or trust would recognize capital gain when the corporation liquidates and distributes its assets; but the shareholder would be taxable only as the installments are paid by the children or trust. [See *Rushing v. Commr.* (5th Cir. 1971) 441 F2d 593, 598]

[8:1159] **Limitations:** However, there are some serious limitations on this device:

- First of all, the deferral will not be recognized if the transferee-purchaser is someone whose ownership of the stock would be "attributed to the selling shareholder" under the stock attribution rules of IRC § 318(a) (*see ¶ 7:232*). [IRC § 453(e)]

- Also, courts generally hold that once the liquidation process has commenced it is too late to shift income by transferring the stock. [*Kinsey v. Commr.* (2nd Cir. 1973) 477 F2d 1058, 1063]

[8:1160 - 8:1165] ***Reserved.***

(3) [8:1166] **Tax-free dissolution of subsidiary:** When one corporation controls another, the subsidiary can be dissolved and its assets distributed to the parent-corporation without recognition of gain (or loss). [IRC § 332]

To qualify, the parent must directly own at least 80% of the total voting shares *and 80% of the total value* of all stock of the subsidiary. [IRC §§ 337(a), 332(b)(1), 1504(a)(2)]

In addition, dissolution must be completed within a single taxable year of the parent (or if a series of distributions is made, within three years after the first distribution). [IRC § 332(b)(2), (3)]

[8:1167 - 8:1168] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(a) [8:1169] **Basis of assets received:** In most cases, the basis of the property received by the parent from the subsidiary will be the same as in the hands of the subsidiary; i.e., a carryover basis. [IRC § 334(b)(1)]

(b) [8:1170] **Section 338 election:** But if the parent purchased such control of the subsidiary within a 12-month period, it may *elect* to treat its basis in the subsidiary's *assets* the same as its basis in the acquired stock (i.e., take a "stepped-up" and *not* a carryover basis of the assets). [IRC § 338]

[8:1171 - 8:1175] ***Reserved.***

b. [8:1176] **Tax consequences to corporation:** As noted above (¶ *8:1151*), a corporation recognizes gain or loss upon a sale and/or distribution of its noncash assets in complete liquidation. The distribution to the shareholders is treated as if the corporation *sold* its assets to the shareholders at *fair market value*, and gain (or loss) is recognized accordingly. [IRC § 336(a)]

(1) [8:1177] **Limitations on recognition of loss:** However, *loss* will not be recognized by the corporation on liquidation if:

• Property is distributed on other than a pro rata basis to a "related" person (as defined in IRC § 267); or

• The property distributed was acquired in a tax-free transaction under IRC § 351 (¶ *3:331 ff.*) or as a shareholder contribution to capital within the past five years; or

• The liquidation is of an 80%-owned subsidiary under IRC § 332 (¶ *8:1166 ff.*). [IRC § 336(d)]

(2) [8:1178] **Converting from C corporation to S corporation:** Corporate-level tax on liquidating sales and distributions cannot be avoided by converting from a regular C corporation to an S corporation (¶ *2:119 ff.*) prior to liquidating. This is because the S corporation must pay tax on any "built in" gains … i.e., gains (appreciation of assets) that arose *before* the conversion, if such gains are recognized by the S corporation, either through sale or distribution to the shareholders, within *five years* after the S election. Gains on sales or distributions within the five-year period are *presumed* to be "built-in" gains, unless the taxpayer establishes otherwise. [IRC § 1374]

8. [8:1179] **Compare—Administrative Dissolution:** A California corporation's powers, rights and privileges may be suspended for, among other things, failure to pay franchise taxes (per Rev. & Tax.C. § 23301, ¶ 6:562 ff.). A corporation that has been so suspended for at least *60 continuous months* is subject to administrative dissolution. [Corps.C. § 2205.5(a)]

a. [8:1180] **Purpose:** So long as a corporation has not formally dissolved, state law continues to impose the $800 minimum annual franchise tax even if the corporation has ceased business. In many cases, years may pass before the shareholders become aware that taxes, penalties and interest have been accruing; at that point, they may simply "walk away" from the corporation rather than go through the trouble and expense of dissolution. The Franchise Tax Board, however, can extinguish an uncollectible debt only after 20 years. Administrative dissolution is designed to eliminate defunct businesses and relieve the FTB of the burden of pursuing uncollectible accounts. [Senate Floor Analyses of AB 2503 (8/18/18); Senate Governance and Finance Committee Analysis of AB 2503 (6/25/18); Assembly Revenue and Taxation Committee Analysis of AB 2503 (4/20/18)]

Administrative dissolution thus differs from other methods of dissolution in that there are no procedures to pay creditors, liquidate assets or distribute any remainder to the shareholders. It is somewhat analogous to a quo warranto proceeding to terminate corporate status (see CCP § 803).

b. Procedure

(1) [8:1181] **Notice to corporation:** The FTB will transmit to the Secretary of State the names and Secretary of State file numbers of corporations subject to administrative dissolution. The Secretary of State must provide 60 days' notice of the pending dissolution on its website (*www.sos.ca.gov*) by listing the corporation's name and file number. The posting must also provide instructions for the corporation to submit to the FTB a written objection to the dissolution before the 60-day period expires. [Corps.C. § 2205.5(c), (d)]

The FTB must also mail written notice to the corporation's "last known address." If the FTB does not have a valid address for the corporation, the posting on the Secretary of State's website will be deemed sufficient notice to the corporation. [Corps.C. § 2205.5(b)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(2) [8:1182] **Dissolution where corporation fails to object:** If the FTB receives no written objection within the 60-day notice period (¶ 8:1181), the Secretary of State will dissolve the corporation by filing a certificate of dissolution. [Corps.C. § 2205.5(f)]

(3) [8:1183] **Objection by corporation; revivor (reinstatement):** If the FTB receives a written objection to the dissolution within the 60-day notice period (¶ 8:1181), the corporation has an additional 90 days from the date the objection is received to (i) apply for revivor (*see ¶ 6:568 ff.*), (ii) file returns and pay or otherwise satisfy all accrued taxes, penalties, and interest, and (iii) fulfill any other requirements necessary for revivor. The FTB may extend the 90-day period for up to an additional 90 days. [Corps.C. § 2205.5(g)(1), (3); see Rev. & Tax.C. § 23310—FTB may abate taxes, interest and penalties for years in which corporation ceased business and had no assets]

If the corporation fulfills the conditions for revivor, the administrative dissolution will be cancelled. [Corps.C. § 2205.5(g)(2)(A)]

If the corporation does not fulfill the conditions for revivor, it will be dissolved as of the later of (i) 90 days after receipt of its written objection or (ii) the date of any extension granted by the FTB. [Corps.C. § 2205.5(g)(2)(B)]

c. [8:1184] **Effect of dissolution:** Administrative dissolution terminates the corporation's corporate rights, powers and privileges. [Corps.C. § 2205.5(*l*)]

(1) [8:1185] **Abatement of taxes:** Administrative dissolution also terminates (abates) the corporation's liability for taxes, interest and penalties, and the FTB may no longer pursue collection. [Corps.C. § 2205.5(h)]

(2) [8:1186] **No discharge of other liabilities:** However, administrative dissolution does not discharge any corporate liability to creditors; nor does it discharge any liability of the directors, shareholders or transferees, or of other persons related to the corporation. [Corps.C. § 2205.5(i)]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:A] Directors' Resolution Re Amendment of Articles of Incorporation

DIRECTORS' RESOLUTION RE
AMENDMENT OF ARTICLES OF INCORPORATION

Whereas, it is in the best interests of this corporation to ___________ *(state purpose(s) of amendment—e.g., to increase corporation's authorized shares, change the corporate name, etc.)* and to amend its Articles of Incorporation accordingly:

BE IT RESOLVED, that the following amendment(s) of the Articles of Incorporation of this corporation *(is/are)* hereby adopted and approved:

E.g., ARTICLE ONE is amended to read as follows:

> *"One: The name of this Corporation is* ___________."

> *ARTICLE FOUR is amended to read as follows: "Four: This Corporation is authorized to* ___________."

RESOLVED FURTHER: That the foregoing amendment(s) of the Articles of Incorporation be submitted to the shareholders of this corporation for their adoption and approval as required by law; and

RESOLVED FURTHER: That the officers of this corporation are authorized and directed to comply with the California Corporate Securities Law of 1968 and to obtain such qualification as may be required thereunder to obtain requisite shareholder approval and effectuate the foregoing articles amendment(s); and

RESOLVED FURTHER: That after such adoption and approval by the shareholders, and obtaining any required qualification from the California Commissioner of Financial Protection and Innovation and in full compliance therewith, the secretary of this corporation is authorized and directed to execute, verify, and file with the California Secretary of State this corporation's Certificate of Amendment of its Articles of Incorporation.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:B] Unanimous Written Consent of Directors to Amendment of Articles of Incorporation

UNANIMOUS WRITTEN CONSENT OF DIRECTORS
OF _____ CORPORATION

The undersigned, being all of the directors of _____ Corporation, a California corporation, unanimously adopt, approve, and consent to the following resolution:

[Here, insert resolutions in the same form as illustrated in Form 8:A*]*

Dated: .... /s/...
Director
/s/...
Director
/s/...
Director

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:C] Written Consent of Shareholders to Amendment of Articles of Incorporation

WRITTEN CONSENT OF SHAREHOLDERS OF
_____ CORPORATION
TO AMEND ITS ARTICLES

The undersigned shareholders of ___________ Corporation, a California corporation, holding of record the number of outstanding shares of capital stock of the corporation as set forth below, hereby adopt, approve, and consent to the following amendment to the articles of incorporation of the corporation:

[Insert Resolution of Amendment in same form as in Form 8:A; e.g., ARTICLE ONE is amended to read as follows: _____]

Date	**Number of Outstanding Shares Held By Shareholders**	**Shareholders**
_____	___________	___________ [Signatures of Shareholders]
_____	___________	___________

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:D] Certificate of Amendment of Articles of Incorporation

CERTIFICATE OF AMENDMENT
OF
ARTICLES OF INCORPORATION

___________ and ___________ certify that:

1. They are the President *(or Vice-President or Chairperson of the Board of Directors)*, and the Secretary *(or Chief Financial Officer, Treasurer, any Assistant Secretary of Assistant Treasurer)*, respectively, of ___________, a California corporation.

2. *[Here insert the resolution of Amendment: see* FORM 8:A*-e.g., "ARTICLE ONE is amended to read as follows: _____"]*

3. The foregoing amendment of Articles of Incorporation has been duly approved by the Board of Directors.

4. *[Alternative where only one class of shares]*

   The foregoing amendment has been duly approved by the required vote of shareholders in accordance with Section 902 *[904]* of the Corporations Code. The corporation has only one class of shares and the number of outstanding shares is _____. The number of shares voting in favor of the amendment equaled or exceeded the vote required. The percentage vote required was more than 50% *[or 66 2/3rds% per Sections 158(c) or 902(f): or 100% per Sections 158(b), 204(b), or 904; or other percentage specified in the Articles]*.

   [Alternative where more than one class of shares outstanding]

   The foregoing amendment has been duly approved by the required vote of shareholders in accordance with Section 903 *[902 or 904]* of the Corporations Code. The corporation has two classes of shares outstanding, each of which is entitled to vote with respect to the amendment. The number of outstanding shares of each class is _____ *[e.g., 100 shares of Preferred stock and 500 shares of Common stock].* The number of shares voting in favor of the amendment equaled or exceeded the vote required. The percentage vote required was more than 50% *[or as otherwise required]* of each class.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

We further declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of our own knowledge.

Dated: ___________

/s/...
President
/s/...
Secretary

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:E] Agreement of Merger

AGREEMENT OF MERGER

This Agreement of Merger is made as of ___________, between BUY-BUY, INC., a California corporation (the "Disappearing Corporation") and TAKEOVER, INC., a California corporation (the "Surviving Corporation"). (The corporations together are sometimes referred to below as the "Constituent Corporations.")

The Constituent Corporations agree as follows:

1. Disappearing Corporation is duly organized, existing and in good standing under the laws of the State of California. It has ___ shares of authorized capital stock; ___ shares are issued and outstanding.

2. Surviving Corporation is duly organized, existing and in good standing under the laws of the State of California. It has ___ shares of authorized capital stock; ___ shares are issued and outstanding.

3. The Boards of Directors of the Constituent Corporations deem it in the best interests of the corporations and their shareholders that Disappearing Corporation be merged with Surviving Corporation in accordance with California Corporations Code Section 1100 et seq. The Boards hereby adopt on behalf of their corporations the plan of reorganization set forth in this Agreement of Merger.

4. Merger: Disappearing Corporation shall be merged with Surviving Corporation, which shall survive the merger. Disappearing Corporation's separate existence shall cease on the effective date of the merger. Without any other transfer or documentation, on the effective date of the merger Successor Corporation shall (i) succeed to all of Disappearing Corporation's rights and property; and (ii) be subject to all Disappearing Corporation's liabilities and obligations. [Optional: All liens on the property of both corporations remain unimpaired, but liens on the Disappearing Corporation's property are limited to the property affected thereby immediately prior to the effective date.]

   Notwithstanding the above, after the effective date the Surviving Corporation's proper officers and directors may perform any acts necessary or desirable to vest or confirm Surviving Corporation's possession of and title to any property or rights of Disappearing Corporation, or otherwise carry out this Agreement's purposes. This includes execution and delivery of deeds, assurances, assignments or other instruments.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

5. Conversion of Shares: By virtue of the merger and without any action by any shareholder, upon the effective date each share of capital stock of Disappearing Corporation outstanding immediately prior to the effective date shall be converted into the right to receive ___ fully paid and nonassessable shares of Surviving Corporation's common stock.

   No fractional shares of Surviving Corporation shall be issued.

   [*Or:* To any holder otherwise entitled as a result of such conversion, a payment by check shall be made by Surviving Corporation of any amount in cash equal to the value of such fraction (at the rate of $________ per whole share or based on the market value of Surviving Corporation's common stock on the effective date.)]

   [*Or:* Any Disappearing Corporation shareholder entitled to 0.50 or more of a share of Surviving Corporation stock shall receive the next higher number of whole shares; and any such shareholder entitled to less than 0.50 of a share of Surviving Corporation stock shall receive the next lower number of shares.]

   The shares of Surviving Corporation outstanding immediately prior to the merger shall not be changed by reason of the merger.

6. Stock Certificates: On or after the effective date, all of Disappearing Corporation's outstanding stock certificates shall be deemed to represent ownership of Surviving Corporation's shares, into which Disappearing Corporation's shares have been converted (as provided above). The holders of such certificates must surrender them to the Surviving Corporation in whatever manner it may legally require. On receipt thereof, Surviving Corporation shall issue and exchange certificates for shares of its common stock representing the number of shares to which the holder is entitled (*where applicable:* together with payment for any fractional shares) as provided above.

   Pending the surrender and exchange of certificates, the registered owner on Disappearing Corporation's books of any outstanding stock certificate shall be entitled to exercise all voting and other rights, and receive any dividends payable, with respect to the shares of Surviving Corporation represented by the certificates (as provided above). [*Or:* Pending the surrender and exchange of certificates, the registered owner on Disappearing Corporation's books of any outstanding stock certificate shall be entitled to exercise all voting and other rights with respect to the shares of Surviving Corporation represented by the certificates, as provided above. But such a certificate holder will not be entitled to receive any dividends payable from Surviving Corporation.]

7. Changes in Articles of Incorporation and Bylaws: Surviving Corporation's Articles of Incorporation as amended and in effect on the effective date shall continue to be its Articles of Incorporation without change as a result of the merger. [*Or:* Surviving Corporation's Articles of Incorporation are amended as follows: ___________]

   Surviving Corporation's Bylaws as amended an in effect on the effective date shall continue to be its Bylaws without change as a result of the merger. [*Or:* Surviving Corporation's Bylaws are amended on the effective date of merger as follows: ___________]

8. Officers and Directors: Surviving Corporation's officers and directors shall continue and remain as such after the effective date for the full unexpired terms of their respective offices, or until their successors have been duly elected or appointed and qualified. [*Or:* As of the effective date, Surviving Corporation's officers and directors shall be as follows: ___________]

9. Effective Date: Provided this Agreement is not abandoned, the effective date of merger shall be at the close of business on the date when this Agreement of Merger with officers' certificates attached is duly filed in the office of the California Secretary of State in accordance with California Corporations Code Section 1103.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

10. Abandonment of Merger: Any time prior to the effective date, this merger may be abandoned without further obligation or liability by action of the board of directors of both of the Constituent Corporations, notwithstanding approval of the merger by their shareholders.

11. Counterparts: This Agreement of Merger may be executed in any number of counterparts, each of which shall constitute an original instrument.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement by their respective duly authorized officers, as of the date first written above.

BUY-BUY, INC.,
a California corporation,
as Disappearing Corporation
BY: ....
TAKEOVER, INC.,
a California corporation,
as Surviving Corporation
BY: ....

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:F

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:F] Certificate of Approval of Agreement of Merger

CERTIFICATE OF APPROVAL
OF AGREEMENT OF MERGER

___________ and ___________ certify that:

1. They are the President *[Vice President, Chairperson of the Board]* and Secretary *[Chief Financial Officer, Treasurer, any Assistant Secretary or Assistant Treasurer]*, respectively, of ___________, a California corporation.

2. The Agreement of Merger in the form attached was duly approved by the Board of Directors of the corporation.

3. *[Alternative where only one class of shares]*

   The corporation has only one class of shares and the total number of outstanding shares is _____. The principal terms of the Agreement of Merger were approved by the vote of a number of shares which equaled or exceeded the vote required. The percentage vote required is more than 50% *[or 66 2/3rds% per Section 1111; 100% per Section 1101; or the percentage specified in the Articles]*.

4. *[Alternative where more than one class of shares outstanding]*

   The number of outstanding shares of each class entitled to vote is ___________ *[e.g., 100 shares Preferred stock and 500 shares Common stock]*. The principal terms of the Agreement of Merger were approved by the vote of a number of shares of each class which equaled or exceeded the vote required. The percentage vote required of each class is more than 50% *[or 66 2/3rds %, 100%, or other as specified in the Articles]*.

5. *[Where applicable]* The California Commissioner of Financial Protection and Innovation has issued a permit for the merger pursuant to Sections 1101.1 and 25142 of the Corporations Code.

We further declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of our own knowledge.

Dated: .... /s/ ....
President

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

/s/ ....
Secretary

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:G

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:G] Demand for Purchase of Shares (Corps.C. § 1301)

DEMAND FOR PURCHASE OF SHARES

To ___________ Corporation:

The undersigned, as record holder of ___________ *[No. and Class]* shares of the corporation with the right to require the corporation to purchase such shares for cash under Section 1300 of the California Corporations Code, and having complied with all conditions precedent to the exercise of such right, does hereby make written demand upon you for the purchase of such shares and payment in cash of their fair market value.

The fair market value of such shares as of the day of and immediately prior to the first announcement of the transaction is $________ per share, at which price the undersigned will sell such shares to you.

[To be used if corporation has not adopted uncertificated shares:]

Enclosed are share certificates Nos. _____, _____, and _____. These certificates are to be endorsed to indicate they represent dissenting shares and returned to me.

Dated: ___________ /s/ ....
Signature of Shareholder

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:H

The Rutter Group | July 2024 Update

California Practice Guide--Corporations

Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:H] Written Consent of Shareholders to Voluntary Dissolution

WRITTEN CONSENT OF SHAREHOLDERS
TO VOLUNTARILY WIND UP AND DISSOLVE
_____ CORPORATION

The undersigned shareholders of ___________ Corporation, a California corporation, holding of record the number of shares of capital stock of the corporation set forth below and representing at least 50% of the voting power, hereby adopt and approve the following action:

WHEREAS, it is in the best interests of the corporation and its shareholders that the corporation be dissolved and its affairs wound up.

RESOLVED, that this corporation hereby elects voluntarily to wind up and dissolve by this action of shareholders.

RESOLVED FURTHER, that the officers of the corporation take such action as may be necessary or proper to wind up the affairs of the corporation and to dissolve it.

Date	No. of Shares Held	Certificate No.	Shareholder
....	....	....	....
			(Signature)
....	....	....	....

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:I

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:I] Directors' Resolution: Election to Wind Up and Dissolve

DIRECTORS' RESOLUTION:
ELECTION TO WIND UP AND DISSOLVE

WHEREAS, the board of directors has determined it to be in the best interest of the corporation to dissolve and wind up its affairs; and

WHEREAS, the board is authorized to commence voluntary dissolution of the corporation pursuant to Corporations Code Section 1900(b) on the ground that: *(e.g., no shares have been issued);*

BE IT RESOLVED that this corporation hereby elects voluntarily to wind up and dissolve, and that its business and affairs be wound up in the manner provided by law;

RESOLVED FURTHER that any of the officers of this corporation is authorized and is hereby directed to file with the Secretary of State, upon behalf of this corporation, a certificate of election to wind up and dissolve as provided by Corporations Code Section 1901; and to take such further action as may be necessary and proper to effect the dissolution of this corporation and the winding up of its affairs.

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:J

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:J] Notice of Commencement of Voluntary Dissolution

NOTICE OF COMMENCEMENT OF VOLUNTARY DISSOLUTION OF ___________, A CORPORATION

TO ALL PERSONS WHO ARE SHAREHOLDERS OR CREDITORS OF ___________, A CORPORATION:

YOU ARE HEREBY NOTIFIED THAT on or about ___________ proceedings were commenced for the voluntary dissolution of said corporation in accordance with Corporations Code Sections 1900 et seq., and that the corporation is now in the process of winding up its affairs in the manner required by law.

Dated: ___________ *\/s/*..
(Signature and corporation office)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:K

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:K] Complaint for Involuntary Dissolution

____
____
____
____
Attorney for ___________
SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF ___________

___________,	)	CASE NO.: ___________
Plaintiff,	)	COMPLAINT FOR INVOLUNTARY DISSOLUTION OF CORPORATION (Corps.C. § 1800)
vs.	)	
___________, a California corporation	)	
Defendant.	)	

....

Plaintiff(s) allege(s) that:

1. Defendant ___________ is a corporation organized and existing under the laws of the State of California, and has its principal office and place of business in the county in which this action is filed.

2. Plaintiffs are the holders of record of more than one-third of the outstanding common shares of said corporation, and are entitled to maintain an action for involuntary dissolution thereof pursuant to Corporations Code Section 1800. (Alternatively, plaintiffs hold shares representing not less than one-third of the total number of outstanding shares, assuming conversion of all preferred shares convertible into common; or, plaintiffs hold shares representing not less than one-third of the equity of the corporation.)

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

3. Grounds exist for involuntary dissolution of said corporation pursuant to Corporations Code Section 1800, to wit: (allege facts showing one of statutory grounds—abandonment of business for more than 1 year, pervasive fraud or mismanagement by those in control, deadlock of directors, dissension among shareholders, etc.).

WHEREFORE, plaintiff(s) pray(s) judgment as follows:

(1) For a decree that defendant ___________ be wound up and dissolved in the manner provided by law;

(2) for such ancillary orders and decrees as may be necessary to effectuate said winding up and dissolution; and

(3) for such other and further relief as the court deems just.

____
(Signature and typed name of attorney for plaintiffs)
(VERIFICATION REQUIRED)

I am one of the plaintiffs in this action. I have read the foregoing complaint. Each of the matters stated therein is true *(except as to matters stated on information and belief, and as to such matters, I believe them to be true)*.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed this _____ day of _____.

____
(Signature and typed name of plaintiff)

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:L

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:L] Notice of Motion to Stay Dissolution and Fix Value of Shares of Shareholders Seeking Dissolution

____
____
____
____
Attorney for ___________
SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF ___________

___________,	)	CASE NO.: ....
Plaintiff,	)	HEARING DATE/TIME: ....
	)	DEPT. NO.: ....
	)	HEARING JUDGE: ___ *(if known)*
vs.	)	NOTICE OF MOTION TO STAY PROCEEDINGS AND FIX VALUE OF SHAREHOLDERS' SHARES
___________,	)	
a California Corporation	)	
	)	DATE ACTION FILED: ....
	)	DATE SET FOR TRIAL: ________________ *(if set)*
Defendant.	)	

To Plaintiff(s) and their attorneys of record:

NOTICE IS HEREBY GIVEN that on ___________, ___________, at _____, or as soon thereafter as the matter may be heard, in Dept. No. _____ of this Court, ___________ Corporation, defendant, will move for an order to stay the proceedings and to fix the value of the shares owned by plaintiff(s). The motion will be made on the grounds that the holders of 50% or more of the outstanding shares of defendant corporation have elected to purchase plaintiffs' shares, are unable to agree with plaintiff(s)

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

on the fair cash value of these shares, and will give bond with sufficient surety to protect the interest and rights of plaintiff(s) and to assure them payment of the fair cash value of their shares.

The motion will be based on this notice of motion, on the declaration of ___________, and the memorandum of points and authorities served and filed together with this motion, on the papers and records on file, and on such further oral and documentary evidence as may be presented at the hearing of the motion.

Dated: ___________ /s/ ....
Attorney for Defendant

ATTACH: *(1)* *Memorandum of Points and Authorities (See Corps.C. § 2000(b).)*
(2) *Declaration of* ___________
(3) *Proof of Service*

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:M

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:M] Order Staying Dissolution and Appointing Appraisers to Determine Value of Shares

____
____
____
____
Attorney for ___________
SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF ___________

___________,	) CASE NO.: ....
Plaintiff,	) ORDER STAYING DISSOLUTION AND APPOINTING APPRAISERS TO FIX VALUE OF PLAINTIFFS' STOCK
vs.	)
___________,	) DATE ACTION FILED: ....
a California Corporation	) DATE SET FOR TRIAL: ___________ *(if set)*
Defendant.	)

The motion of ___________, a California corporation, to stay these proceedings and to fix the value of the shares held by plaintiffs came on regularly for hearing before this Court on ___________, _____, with ___________ appearing as attorney for the moving party and ___________ appearing as attorney for plaintiff. The court having received proof, and good cause appearing:

IT IS HEREBY ORDERED that:

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1. All further proceedings in the above-entitled action for involuntary winding up and dissolution are stayed pending fixing by the Court of the fair cash value of plaintiffs' shares in accordance with this order.

2. ___________ shall deposit with the Court a bond, with surety satisfactory to this Court, in the amount of $________, to protect the interests and rights of plaintiffs in defendant corporation, and to ensure payment to plaintiffs of the fair cash value of their shares and reimbursement of their reasonable expenses in the event their shares are not purchased within the time to be specified in further orders of this Court.

3. The following persons are appointed as appraisers and are directed to appraise the fair cash value of the shares owned by plaintiffs pursuant to Corporations Code § 2000, and to report this value to the court within ___________ days from the date of this order: ___________

Dated: ___________ /s/ ....

Judge of the Superior Court

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:N

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:N] Order for Winding Up and Dissolution if Appraised Value of Shares not Paid, and for Award of Expenses

____
____
____
____
Attorney for ___________
SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF ___________

___________, Plaintiff, vs. ___________, a California Corporation Defendant.	))))))))))))))	CASE NO.: .... ORDER FOR WINDING UP AND DISSOLVING IF APPRAISED VALUE OF SHARES NOT PAID AND FOR AWARD OF EXPENSES

The Appraisers appointed by the above-entitled court to determine the value of the shares of defendant corporation held by plaintiff having reported to the court on ___________, _____ that the value of said shares shall be _____ dollars per share.

IT IS HEREBY ORDERED THAT:

1. The determination by the Appraisers is confirmed. The value of shares of ___________ Corporation is $________ per share.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2. The sum of $________ is to be paid to plaintiff by ___________ and ___________ *(name of surety on bond)* within ten (10) days after entry of this decree; provided that if this payment is not made within such time the involuntary winding up and dissolution of defendant corporation shall proceed immediately.

3. If ___________ shareholder and ___________ *(name of surety)* do not make payment for plaintiff's shares within such ten (10) day period, ___________ and shall pay all of plaintiff's expenses, including reasonable attorney's fees.

4. On receipt of payment or tender as is ordered in this decree, plaintiff shall transfer the ___________ shares to ___________.

Dated: ___________

/s/ ....

Judge of the Superior Court

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:O

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:O] Notice to Creditors to Present Claims

____
____
____
____
Attorney for ___________
SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF ___________

___________,	)	CASE NO.: ___________
Plaintiff,	)	NOTICE TO CREDITORS TO PRESENT CLAIMS
vs.	)	
___________, a California Corporation	)	
Defendant.	)	

To creditors and claimants of ___________, a California corporation:

NOTICE IS HEREBY GIVEN that proceedings have been commenced for the winding up and dissolution of ___________, a California corporation, and that the above-entitled Court has assumed jurisdiction over these proceedings.

Creditors and claimants may be barred from participation in any distribution of the general assets of the corporation unless they make and present claims and proofs at the corporation's offices at ___________, no later than ___________*(date)*.

BY ORDER OF THE COURT.
DATED: ___________

....
[Typed name of corporation]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[Signature of corporate officer]

....

[Typed name and title]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Form 8:P

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 8. Corporate Changes and Dissolution

Forms

[Form 8:P] Order Declaring Corporation Wound Up and Dissolved

____
State Bar No. ________________
____
____
____
Attorneys for: ....

SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF ___________

___________,	)	CASE NO. ___________
Plaintiff,	)	
	)	ORDER DECLARING CORPORATION DULY WOUND UP AND DISSOLVED
vs.	)	
___________,	)	
a California Corporation	)	
Defendant.	)	

....

The above entitled matter having been heard by this court on _____ at ___________, on the petition of ___________, a California corporation, made in its name by its directors for an order declaring said corporation to be duly wound up and dissolved, made and filed herein on ___________; ___________ appearing as attorney for ___________; and ___________ appearing as attorney for ___________; and the court being fully advised:

IT IS HEREBY ORDERED THAT ___________, a California corporation, be and it hereby is declared to be duly wound up; a final franchise tax return, as described by Section 23332 of the Revenue and Taxation Code, has been filed with the Franchise Tax Board as required under Part 10.2 (commencing with Section 18401) of Division 2 of the Revenue and Taxation Code; its

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

known debts and liabilities have been actually paid; its known assets have been distributed to the persons entitled thereto; the accounts of its directors or such other persons as set forth in said petition have been settled; and its directors are discharged from their duties and liabilities to creditors and shareholders.

IT IS FURTHER HEREBY ORDERED that said corporation be and it hereby is declared to be dissolved.

DATED: ___________

....
Judge of the Superior Court

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9-A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part I. Social Purpose Corporations

A. Introduction and Background

1. [9:2] Relationship to Benefit Corporations
2. [9:3] Governing Law
    a. [9:3.1] Prior law ("flexible purpose corporations")
3. [9:4] Taxed as Corporation
4. [9:5] Corporate Powers Subject to SPC's Purpose
5. [9:6] Secretary of State Filing Fees

[9:1] A social purpose corporation (SPC) is a *for-profit* corporation that may pursue *environmental* or other *public purpose objectives*. An SPC may be attractive to companies marketing to socially responsible consumers or seeking capital from socially motivated investors.

Nonprofit corporations often prove unsuitable for "*social* entrepreneurs" because the Internal Revenue Code and regulations severely restrict the for-profit activities of a nonprofit corporation, and the process of seeking tax-exempt status can be lengthy. On the other hand, the two business forms available to *for-profit* entrepreneurs—the corporation and the limited liability company—have downsides when social objectives are combined with profit-making goals. These downsides are especially problematic when traditional investment capital is sought. [See Senate Floor Analysis of SB 201 (8/30/11)]

[9:1.1] **Secretary of State Filing Data:** The number of SPCs and benefit corporations (¶ 9:500 ff.) organized to date is limited. The following are the number of entities filing articles of incorporation as SPCs, benefit corporations and *all* for-profit California corporations for the years 2012-2021, as reported by the Secretary of State:

Year	Articles Filed by SPCs	Articles Filed by Benefit Corps.	Articles Filed by All For-Profit Corps.
2012	33	86	70,664
2013	23	50	76,548
2014	12	59	79,183
2015	36	81	85,058
2016	11	70	85,870
2017	6	61	89,404
2018	3	50	101,198
2019	16	60	94,807
2020	7	26	103,176
2021	5	18	102,615

1. [9:2] **Relationship to Benefit Corporations:** *See ¶ 9:503 ff.*

2. [9:3] **Governing Law:** SPCs are governed by the Social Purpose Corporations Act (SPCA), codified in Corporations Code Division 1.5 (Corps.C. § 2500 et seq.). [Corps.C. § 2500]

However, except as otherwise expressly provided in the SPCA, an SPC is subject to the General Corporation Law (Corps.C. § 100 et seq.) that governs all other for-profit corporations. [Corps.C. § 2501]

a. [9:3.1] **Prior law ("flexible purpose corporations"):** Prior to 2015, SPCs were known as "flexible purpose corporations." A corporation formed before 2015 as a "flexible purpose corporation" may, but need not, change its status to an SPC by amending its articles to change its name to replace "flexible purpose corporation" with "social purpose corporation" and to replace the term "flexible purpose corporation" with "social purpose corporation" in any statements contained in its articles. [Corps.C. §§ 2601(b)(3), 2602(b)(3)]

A flexible purpose corporation that has not so amended its articles is still governed by the SPCA, and any reference in the SPCA to a "social purpose corporation" is deemed a reference to a "flexible purpose corporation." [Corps.C. §§ 2502, 2601(b)(3)]

3. [9:4] **Taxed as Corporation:** Although an SPC may combine environmental or other public purpose objectives with profit-making objectives, it has no special tax benefits: An SPC is taxed as a for-profit corporation under both federal and California tax law. (But an SPC may elect to be taxed as an S corporation; *see* ¶ *2:119 ff., 4:480 ff.*)

4. [9:5] **Corporate Powers Subject to SPC's Purpose:** An SPC, like a corporation organized under the General Corporation Law, enjoys broad authority to engage in any business activity, subject to any limitation contained in its articles and to compliance with applicable laws. [Corps.C. §§ 2604, 2605; see Corps.C. §§ 206 & 207 (*discussed at* ¶ *4:9 ff.*)]

However, an SPC is subject to the additional limitation that its business activity must be *consistent with its special purpose* (*see* ¶ *9:23 ff.*). [Corps.C. §§ 2604, 2605, 1st para.]

5. [9:6] **Secretary of State Filing Fees:** The Secretary of State's fees for filing instruments by or on behalf of SPCs are the same as for other corporations. [Corps.C. § 2502.05]

[9:7 - 9:20] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9-B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part I. Social Purpose Corporations

B. Formation

- 1. Articles of Incorporation
  - a. Required provisions
    - (1) [9:22] Name
    - (2) [9:23] General purpose statement
      - (a) [9:23.1] Compare—corporations formed before 2015
    - (3) [9:24] Specific purpose statement
    - (4) [9:25] Reference to SPCA
    - (5) [9:26] Corporations subject to banking or insurer laws
    - (6) [9:27] Professional corporations
    - (7) [9:28] Close corporations
    - (8) [9:29] Initial agent for service of process
    - (9) [9:29.1] Corporation's street/mailing address
    - (10) [9:30] Share structure
      - (a) [9:31] Single class of shares
      - (b) [9:32] Several classes of shares
  - b. [9:41] Optional provisions
    - (1) [9:42] Restrictions on SPC's business or powers
    - (2) [9:43] Limitations on directors' liabilities
    - (3) [9:44] Indemnification of corporate agents
    - (4) [9:45] Exception for statutory close corporation?
  - c. [9:46] Reference to outside facts or documents
- 2. [9:56] Formation by Conversion or Change of Status
  - a. [9:57] Merger of nonSPC corporation into SPC
  - b. [9:58] Dissenters' rights
- 3. [9:60] Issuance of Shares and Share Certificates
  - a. [9:61] Legend requirement applicable to all SPCs
  - b. [9:62] Legend requirement applicable to SPC close corporations
  - c. [9:63] Compare—corporations formed before 2015

[9:21] The paragraphs below (¶ 9:22 ff.) set forth the provisions of the Social Purpose Corporations Act that apply specifically to SPCs. Except as otherwise described, the procedure for forming an SPC is the same as for a corporation organized under the General Corporation Law (*see Chs. 3 & 4*).

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1. Articles of Incorporation

a. Required provisions

(1) [9:22] **Name:** The name of the SPC as set forth in the articles *must* contain the words "social purpose corporation" or an abbreviation thereof. [Corps.C. § 2602(a); *see ¶ 3:402 ff.* re name requirements]
(2) [9:23] **General purpose statement:** The articles *must* also set forth *either* of the following statements, as applicable:

- "The purpose of this social purpose corporation is to engage in any lawful act or activity for which a social purpose corporation may be organized under Division 1.5 of the California Corporations Code, other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code, for the benefit of the overall interests of the social purpose corporation and its shareholders and in furtherance of the following enumerated purposes _____." [Corps.C. § 2602(b)(1)(A)]

- "The purpose of this social purpose corporation is to engage in the profession of _____ (with the insertion of a profession permitted to be incorporated by the California Corporations Code) and any other lawful activities, other than the banking or trust company business, not prohibited to a social purpose corporation engaging in that profession by applicable laws and regulations, for the benefit of the overall interests of the social purpose corporation and its shareholders and in furtherance of the following enumerated purposes _____." [Corps.C. § 2602(b)(1)(B)]
  (a) [9:23.1] **Compare—corporations formed before 2015:** A corporation that was organized before 2015 as a "flexible purpose corporation" and that has not elected to change its status to an SPC (*see ¶ 9:3.1*) is not required to revise its general purpose statement to conform to the current version of Corps.C. § 2602(b)(1). [Corps.C. § 2602(b)(3)(A)]

(3) [9:24] **Specific purpose statement:** In addition to a general purpose statement (¶ 9:23), the articles must set forth one or more of the following purposes:

- One or more charitable or public purpose activities that a *nonprofit* "public benefit corporation" (Corps.C. § 5110 et seq.) is authorized to carry out. [Corps.C. § 2602(b)(2)(A); see Corps.C. § 5111—nonprofit "public benefit corporation" may be formed "for any public or charitable purposes"]

- Promoting positive effects of, or minimizing adverse effects of, the SPC's activities upon any of the following:

  — the SPC's employees, suppliers, customers and creditors;

  — the community and society; or

  — the environment. [Corps.C. § 2602(b)(2)(B)]

However, the corporation must consider this purpose in addition to or together with the shareholders' financial interests and the SPC's compliance with legal obligations, and take action consistent with this purpose. [Corps.C. § 2602(b)(2)(B)]

(4) [9:25] **Reference to SPCA:** The articles must include a statement that the SPC is organized as a social purpose corporation under the Social Purpose Corporations Act. [Corps.C. § 2602(b)(3)(B)]
(5) [9:26] **Corporations subject to banking or insurer laws:** The articles must contain additional statements if the SPC is subject to the Banking Law (Fin.C. § 1000 et seq.) or the Insurance Code as an insurer. [Corps.C. § 2602(b)(4), (5); see Corps.C. §§ 2510, 2510.1]
(6) [9:27] **Professional corporations:** If the SPC is a professional corporation (*see ¶ 2:244 ff.*), the articles must set forth the statement required by Corps.C. § 13404 (¶ 2:248.1). [Corps.C. § 2602(b)(6)]
  ➪ [9:27.1] ***PRACTICE POINTER:*** In the situation of professions subject to a licensing or regulatory authority (e.g., the State Bar in the case of attorneys), the SPC entity form may have to be approved by that authority before it may be used.
(7) [9:28] **Close corporations:** If the SPC is a statutory close corporation (*see ¶ 3:233 ff.*), the articles must set forth the statement required by Corps.C. § 158 (¶ 3:238). [Corps.C. § 2602(b)(7); see Corps.C. § 2503.1]

(8) [9:29] **Initial agent for service of process:** The articles must state the name and California street address of the corporation's initial agent for service of process. [Corps.C. § 2602(c); *see* ¶ 4:23 ff.]

(9) [9:29.1] **Corporation's street/mailing address:** The articles must also state the corporation's initial street address; and must also state the corporation's initial mailing address if it is different from the initial street address. [Corps.C. § 2602(d), (e)]

(10) [9:30] **Share structure:** The articles must state the corporation's authorized share structure.

(a) [9:31] **Single class of shares:** If the articles authorize only a single class of shares, the total number of shares that the corporation is authorized to issue must be stated. [Corps.C. § 2602(f); *see* ¶ *4:29 ff.*]

(b) [9:32] **Several classes of shares:** If more than one class of shares is authorized (or if any class is to have several series), the articles must state, *or specifically authorize the board of directors to determine:*

• The total number of shares authorized within each class or series;

• The designation of each class or series;

• The rights, preferences, privileges and restrictions of each such class or series. [Corps.C. § 2602(g)(1)-(3); *see* ¶ *4:35 ff.*]

[9:33 - 9:40] ***Reserved.***

b. [9:41] **Optional provisions:** SPC articles, like the articles of corporations organized under the General Corporation Law, *may* include other optional provisions; some of these may be included in the bylaws instead of the articles, and others *must* be included in the articles to be effective (*see* ¶ *4:50 ff.*). Except as noted below (¶ 9:42 ff.), the optional provisions applicable to SPCs as set forth in Corps.C. § 2603(a) are identical to those set forth in the General Corporation Law (see Corps.C. § 204). [Corps.C. § 2603(a)]

(1) [9:42] **Restrictions on SPC's business or powers:** Corps.C. § 2603(a)(6) differs from its General Corporation Law counterpart (Corps.C. § 204(a)(6); *see* ¶ *4:64*): The SPC's articles may contain an optional provision limiting or restricting the business in which the SPC may engage or the powers that the SPC may exercise "*[s]o long as consistent with the purpose of the social purpose corporation as set forth in the articles."* [Corps.C. § 2603(a)(6) (emphasis added); *see* ¶ *9:24*]

(2) [9:43] **Limitations on directors' liabilities:** There are also some differences between Corps.C. § 2603(a)(10) and its General Corporation Law counterpart (Corps.C. § 204(a)(10); *see* ¶ *4:88.1 ff.*). An optional articles provision eliminating or limiting an SPC director's personal liability for monetary damages in a derivative action or in a direct action by the corporation may not eliminate or limit director liability for:

• Acts or omissions involving intentional misconduct or knowing and culpable violations of law;

• Conduct that involves an absence of good faith or that a director believes contrary to the best interests of the SPC or its shareholders *and its corporate purposes as expressed in the articles;*

• Transactions in which the director derives an improper personal benefit;

• Reckless disregard of duty to the SPC or its shareholders when the director was (or should have been) aware in the ordinary course of performing a director's duties of a risk of serious injury to the SPC, its shareholders *or its corporate purposes as expressed in the articles;*

• Unexcused inattention, amounting to an "abdication" of a director's duty to the SPC, its shareholders *or its corporate purposes as expressed in its articles;*

• Transactions in which the director has a conflict of interest (see Corps.C. § 310, ¶ 6:286 ff.); or

• Prohibited corporate loans or distributions (see Corps.C. § 2701, ¶ 9:84). [Corps.C. §§ 2603(a)(10)(A) & (11), 2702(b)]

(3) [9:44] **Indemnification of corporate agents:** The articles of a corporation organized under the General Corporation Law may contain a provision authorizing indemnification of corporate agents "in excess of that expressly permitted by

Section 317 for those agents" in cases involving breach of duty to the corporation or its shareholders. [Corps.C. § 204(a)(11) (emphasis added); *see* ¶ *6:464.1*]

The statutory provision applicable to SPCs (Corps.C. § 2603(a)(11)) similarly allows an SPC to adopt an optional articles provision authorizing the indemnification of SPC agents, *but does not include the above-quoted language*. The reason is that the SPC indemnification provisions differ markedly from the General Corporation Law indemnification provisions (*see* ¶ *9:121 ff.*). The purpose of Corps.C. § 204(a)(11) is to authorize indemnification *exceeding* the indemnification permitted by statute. Indeed, the absence of the above-quoted language largely renders Corps.C. § 2603(a)(11) a nullity … because the corporation always has authority to indemnify agents to the extent permitted by law. [Corps.C. § 2603(a)(11), 2nd para.]

(4) [9:45] **Exception for statutory close corporation?** The General Corporation Law permits a statutory close corporation to include the optional articles provisions in its shareholders agreement rather than in the articles. [Corps.C. § 204(a), last sent.; *see* ¶ *3:243.1*]

Corps.C. § 2603(a) does not contain a comparable provision applicable to SPCs that are also statutory close corporations. It is not clear whether this was a legislative oversight or whether the intention was to require a statutory close SPC to place certain provisions in its articles (which are publicly available).

c. [9:46] **Reference to outside facts or documents:** Articles provisions of SPCs, like articles provisions of corporations organized under the General Corporation Law, may be made dependent upon facts ascertainable outside the articles so long as the manner in which the extraneous facts operate on those provisions is clearly and expressly set forth in the articles. [Corps.C. § 2502.06; *see* ¶ *4:60.1 ff.*]

[9:47 - 9:55] ***Reserved.***

2. [9:56] **Formation by Conversion or Change of Status:** An SPC may be formed by conversion from a noncorporate business entity so long as the other entity is authorized by the laws under which it is organized to effect the conversion. [Corps.C. § 3307(a); *see* ¶ *8:531 ff.*]

An SPC may also be formed by a nonSPC corporation's *change of status* (by way of an articles amendment) to that of an SPC. (Such an amendment requires approval of two-thirds of the outstanding shares of each class.) [Corps.C. § 911(a), (d); *see* ¶ *6:27.1*]

a. [9:57] **Merger of nonSPC corporation into SPC:** A nonSPC corporation can also become an SPC by merging into an SPC; *see* ¶ *9:312 ff.*

b. [9:58] **Dissenters' rights:** Shareholders of a nonSPC corporation merging into an SPC have the full dissenters' rights set forth in the General Corporation Law (*see* ¶ *8:292 ff.*). [Corps.C. § 1112.5(b)]

But a *change of status* from a nonSPC corporation to an SPC by way of an articles amendment (¶ 9:56) does *not* trigger dissenters' rights. [See Corps.C. § 911; *and* ¶ *8:293.5 ff.*]

[9:59] ***Reserved.***

3. [9:60] **Issuance of Shares and Share Certificates:** The General Corporation Law provisions governing issuance of shares and share certificates (Corps.C. § 400 et seq.) apply to SPCs, with two differences pertaining to legend requirements. [See Corps.C. § 2501]

a. [9:61] **Legend requirement applicable to all SPCs:** The certificates representing the shares of an SPC must include the following *conspicuous* language on the *face* of the certificate:

> "This entity is a social purpose corporation organized under Division 1.5 of the California Corporations Code. The articles of this corporation state one or more purposes required by law. Refer to the articles on file with the Secretary of State, and the bylaws and any agreements on file with the secretary of the corporation, for further information." [Corps.C. § 2800(a)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

b. [9:62] **Legend requirement applicable to SPC close corporations:** The certificates representing the shares of an SPC that is a statutory close corporation (*see* *¶ 3:233 ff.*) must also include the following *conspicuous* language on the *face* of the certificate:

> "This social purpose corporation is a close social purpose corporation. The number of holders of record of its shares cannot exceed ___ (a number not in excess of 35). Any attempted voluntary inter vivos transfer which would violate this requirement is void. Refer to the articles, bylaws and any agreements on file with the secretary of the social purpose corporation for further restrictions." [Corps.C. § 2800(d)]

c. [9:63] **Compare—corporations formed before 2015:** Share certificates of a corporation organized before 2015 as a "flexible purpose corporation" remain valid even if the certificates reference a "flexible purpose corporation," and any reference to a "flexible purpose corporation" in the certificates is deemed a reference to a "social purpose corporation." (The corporation may, but need not, reissue certificates to replace "flexible purpose corporation" with "social purpose corporation.") [Corps.C. § 2800(f)]

[9:64 - 9:80] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9-C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part I. Social Purpose Corporations

C. Directors' Duties

1. [9:82] General Fiduciary Duty of Care
2. [9:83] Reliance Upon Officers and Experts
3. [9:84] Responsibility for Distributions
4. [9:91] Compare—SPC Directors' Duties Differing From GCL Directors
    a. [9:92] Consideration of SPC's prospects and purposes
    b. [9:93] SPC assets held for shareholders
        (1) [9:94] Limitation re charitable trust
    c. [9:95] No duties under SPCA to third persons
        (1) [9:96] Comment

[9:81] The duties of the directors of an SPC generally are the same as the duties of the directors of corporations organized under the General Corporation Law. However, there are some important variations (¶ 9:91 ff.).

1. [9:82] **General Fiduciary Duty of Care:** Like directors of corporations organized under the General Corporation Law, SPC directors must perform their duties in *good faith*, in a manner the director *believes* to be in the *best interests of the corporation and its shareholders*, and with that *care*, including *reasonable inquiry*, as an *ordinarily prudent person* in a like position would use under similar circumstances. [Corps.C. § 2700(a); *see ¶ 6:244*]

2. [9:83] **Reliance Upon Officers and Experts:** An SPC director may rely, to the same extent as a director of a corporation organized under the General Corporation Law, on corporate officers and employees; counsel, independent accountants and other professionals; and committees of the board of directors. [Corps.C. § 2700(b); *see ¶ 6:248 ff.*]

3. [9:84] **Responsibility for Distributions:** SPC directors are liable for improper dividends and distributions to the same extent as directors of corporations organized under the General Corporation Law. [Corps.C. § 2701; *see ¶ 7:142 ff.*]

[9:85 - 9:90] ***Reserved.***

4. [9:91] **Compare—SPC Directors' Duties Differing From GCL Directors:** There are a few significant variations applicable to SPC director duties that do not apply to directors of corporations organized under the General Corporation Law.
    a. [9:92] **Consideration of SPC's prospects and purposes:** In discharging their duties, SPC directors may "consider those factors, and give weight to those factors, as the director deems relevant, including the overall prospects of the social purpose

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

corporation, the best interests of the social purpose corporation and its shareholders, and the purposes of the social purpose corporation as set forth in its articles." [Corps.C. § 2700(c)]

b. [9:93] **SPC assets held for shareholders:** Notwithstanding any of the purposes set forth in the SPC's articles, an SPC is not deemed to hold any of its assets for the benefit of any party other than its shareholders. [Corps.C. § 2700(e)]

(1) [9:94] **Limitation re charitable trust:** However, nothing in the Social Purpose Corporations Act "shall be construed as negating existing charitable trust principles or the Attorney General's authority to enforce any charitable trust created." [Corps.C. § 2700(e)]

c. [9:95] **No duties under SPCA to third persons:** Although the Social Purpose Corporations Act expands directors' duties to encompass the SPC's purposes, these expanded duties do not "create or grant any right in or for any person," and "a director shall not be responsible to any party" other than the SPC and its shareholders. [Corps.C. § 2700(f)]

(1) [9:96] **Comment:** The above-quoted language (Corps.C. § 2700(f); ¶ 9:95) could easily be misinterpreted as meaning a director's duties are strictly limited to the SPC and its shareholders. Clearly, an SPC director will continue to have responsibilities to third persons under laws other than the Social Purpose Corporations Act. The intention here is probably to make clear that the SPC's social or environmental pursuits do not create rights in the intended *beneficiaries* (or *recipients*) of those pursuits, whether those beneficiaries be individuals, classes of persons, or society as a whole.

[9:97 - 9:120] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9-D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part I. Social Purpose Corporations

D. Indemnification of Directors, Officers, Employees and Others

1. [9:122] Indemnification of Agents and Others Against *Any* Claims
    a. [9:123] "Agent"
    b. [9:124] Indemnification of other persons
        (1) [9:125] Limitation—employee benefit plan fiduciaries
    c. [9:126] Limitation—no indemnity for highly culpable misconduct ("seven deadly sins") in derivative suit or direct action by SPC
    d. General Corporation Law compared
        (1) [9:131] "Good faith" vs. "seven deadly sins" limitation
        (2) [9:132] Indemnification not limited to "agents"
        (3) [9:133] Not limited to "proceedings"
        (4) [9:134] "Mandatory" indemnification?
        (5) [9:135] Special approval requirements in derivative suits and direct actions by corporation?
        (6) [9:136] Express authorization required?
2. [9:146] Advancing Defense Costs
    a. [9:147] Repayment undertaking required?
3. [9:148] Liability Insurance

[9:121] Like a corporation organized under the General Corporation Law, an SPC may indemnify its directors, officers and corporate personnel against claims and expenses, including attorney fees. However, the indemnification provisions in the Social Purpose Corporations Act vary considerably from those contained in the General Corporation Law. [Corps.C. § 2702]

➪ [9:121.1] ***CAUTION—SPCA AS SUPPLEMENTING GCL INDEMNIFICATION*:** As stated at the outset (¶ 9:3), an SPC is subject to the General Corporation Law *except as otherwise expressly provided* in the Social Purpose Corporations Act. [Corps.C. § 2501]

The Social Purpose Corporations Act was intended to *expand* upon the indemnification provisions under the General Corporation Law; hence, an SPC is authorized to indemnify under both Corps.C. § 2702 (SPCs) and Corps.C. § 317 (GCL corporations). However, this approach produces some uncertainties, as noted below (*see ¶ 9:131 ff.*).

1. [9:122] **Indemnification of Agents and Others Against *Any Claims:*** An SPC may indemnify any "agent" (¶ 9:123) "*from and against any and all claims and demands whatsoever*." [Corps.C. § 2702(a)(1), (b) (emphasis added)]

However, this indemnification provision is subject to any standards and restrictions set forth in the SPC's articles or bylaws. Also, while this provision provides broad indemnification for claims by third parties, in the situation of duties owed to the *SPC and its shareholders*, it is subject to statutory limitations on indemnification found in Corps.C. § 2603(a)(11) (the "seven deadly sins," ¶ 9:126). [Corps.C. § 2702(b)]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

a. [9:123] **“Agent”:** For purposes of the § 2702 indemnification provisions, an “agent” is any person who:

— is or was a *director, officer, employee or other agent* of the SPC; or

— is or was *serving at the SPC's request* as a director, officer, employee or agent of another foreign or domestic corporation, partnership, joint venture, trust or other enterprise; or

— was a director, officer, employee or agent *of a foreign or domestic corporation that was a predecessor corporation* of the SPC or another enterprise at the request of the predecessor corporation. [Corps.C. § 2702(a)(1)]

b. [9:124] **Indemnification of other persons:** Indemnification regarding “any and all claims” under § 2702(b) is not limited to SPC agents (*see ¶ 9:132*); it extends to “any other person.” [Corps.C. § 2702(b)]

(1) [9:125] **Limitation—employee benefit plan fiduciaries:** Corps.C. § 2702 does not authorize indemnification in any “proceeding” against a trustee, investment manager or other employee benefit plan fiduciary in that person's capacity as such. However, the SPC may indemnify such persons pursuant to Corps.C. § 2605(f), which broadly permits the SPC to “indemnify and purchase and maintain insurance on behalf of” any employee benefit plan fiduciary. [Corps.C. §§ 2605(f), 2702(e)]

c. [9:126] **Limitation—no indemnity for highly culpable misconduct (“seven deadly sins”) in derivative suit or direct action by SPC:** An SPC *cannot* indemnify SPC directors or other agents against liability *to the SPC or its shareholders* for:

• Acts or omissions involving *intentional misconduct* or *knowing and culpable violations of law;*

• Conduct that involves an absence of good faith or that a director *believes* to be contrary to the *best interests of the SPC or its shareholders* and its *corporate purposes* as expressed in its articles;

• Transactions in which the agent derived an *improper personal benefit;*

• *Reckless disregard* of duty to the SPC or its shareholders when the agent was (or should have been) aware in the ordinary course of performing duties of a *risk of serious injury* to the SPC, its shareholders, or its corporate purposes as expressed in its articles;

• *Unexcused inattention* amounting to an “*abdication*” *of duty* to the SPC, its shareholders or its corporate purposes as expressed in its articles;

• Transactions in which the agent has a *conflict of interest* (see Corps.C. § 310, ¶ 6:286 ff.); or

• Prohibited corporate loans or distributions (see Corps.C. § 2701, ¶ 9:84). [Corps.C. §§ 2603(a)(10)(A) & (11), 2702(b); *see ¶ 6:250.6*]

➪ [9:127] ***PRACTICE POINTER:*** The Corps.C. § 2702(b) provision permitting an SPC to indemnify any person “from and against any and all claims and demands” is modeled after a comparable provision of Delaware law pertaining to limited liability companies. [See 6 Del.C. § 18-108]

Hence, authority interpreting the Delaware provision may be helpful in interpreting Corps.C. § 2702(b).

[9:128 - 9:130] ***Reserved.***

d. General Corporation Law compared

(1) [9:131] **“Good faith” vs. “seven deadly sins” limitation:** With respect to claims *by third parties*, the indemnification permitted SPCs appears far broader than the indemnification permitted corporations organized under the General Corporation Law: The GCL limits indemnification (whether for claims asserted by third parties or claims asserted by the corporation or its shareholders) to acts performed “in good faith and in a manner the person reasonably believed to be in the best interests of the corporation” (and, in the case of a criminal proceeding, with no reasonable cause to believe the conduct was unlawful). The SPC indemnification provision (*see ¶ 9:122*) does *not* contain the limitation that the agent

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

acted "in good faith and in a manner the person reasonably believed to be in the best interests of the corporation." [Corps.C. §§ 317(b), (c), 2702(b); *see* ¶ 6:446 ff.]

However, with respect to claims *by the SPC or its shareholders*, the SPC *cannot* indemnify against the "seven deadly sins" (¶ 9:126), which in some respects appear *narrower* than the "good faith" limitation (*see ¶ 6:250.7*).

The "good faith" indemnification provisions of the General Corporation Law are not necessarily inconsistent with the "seven deadly sins" indemnification provision of the Social Purpose Corporations Act. The SPC could adopt a bylaw provision allowing indemnification only upon a finding by the board that the person to be indemnified acted in good faith and in a manner reasonably believed to be in the SPC's best interests. Thus, the SPC could in effect adopt the Corps.C. § 317(b) and (c) indemnification provisions, and the "seven deadly sins" would remain as the ultimate restrictions on indemnification.

(2) [9:132] **Indemnification not limited to "agents":** Indemnification under the General Corporation Law is limited to those persons who qualify as corporate "agents." This is a fairly broad standard because it encompasses—in addition to corporate directors, officers and employees—any "other agent" of the corporation. However, under the GCL, other "agent" requires some actual *common law agency relationship*. The ability of an SPC to indemnify "any other person" would appear to impose *no limitation* on whom the corporation may indemnify. [See Corps.C. § 317(a), (b); ¶ 6:436, 6:459.5]

(3) [9:133] **Not limited to "proceedings":** A corporation organized under the General Corporation Law can indemnify an agent for amounts actually and reasonably incurred in connection with a "proceeding," defined as a civil, criminal, administrative or investigative proceeding, whether threatened or actual. [Corps.C. § 317(a), (b); ¶ 6:436]

An SPC can indemnify against any "claims" or "demands" (¶ 9:122); thus, indemnification may be made even where no formal "proceeding" has been brought or is threatened.

(4) [9:134] **"Mandatory" indemnification?** A corporation organized under the General Corporation Law *must* indemnify an "agent" to the extent the agent was successful on the merits in any "proceeding." [See Corps.C. § 317(d); ¶ 6:439 ff.]

There is no comparable provision applicable to SPCs under the Social Purpose Corporations Act. Thus, it might appear that all indemnification by an SPC is *permissive* (*discretionary*), and an SPC need not indemnify an SPC officer, director, employee or other agent who successfully defends a claim or demand. On the other hand, one could argue that the Corps.C. § 317 mandatory indemnification provision applies to SPCs for the reason that the General Corporation Law governs SPCs unless the Social Purpose Corporations Act expressly states otherwise (Corps.C. § 2501, ¶ 9:3).

In any event, indemnification may be required as a matter of law when an SPC employee succeeds in defending a third-party claim. [See Lab.C. § 2802(a) (indemnification of employee's expenses incurred in discharge of duties); see also Rest.2d Agency § 439; and *Nicholas Laboratories, LLC v. Chen* (2011) 199 CA4th 1240, 1251, 132 CR3d 223, 231-232—Lab.C. § 2802(a) does not require employer to "indemnify" employee for attorney fees incurred in defending *employer's* action brought against employee]

(5) [9:135] **Special approval requirements in derivative suits and direct actions by corporation?** Corporations organized under the General Corporation Law are limited in the extent to which they may indemnify agents named as defendants in derivative actions by the shareholders and direct actions by the corporation:

- Where the agent is adjudged *liable*, indemnification is permitted only where the court determines the agent is "fairly and reasonably entitled to indemnity"; and

- No indemnification may be made of amounts paid or expenses incurred in *settling* an action *without court approval*. [Corps.C. § 317(c), ¶ 6:455 ff.]

The Social Purpose Corporations Act does not impose comparable limitations on an SPC's indemnity powers. It is not clear whether the limitations imposed by the General Corporation Law apply to SPCs (*see ¶ 9:121.1*).

(6) [9:136] **Express authorization required?** Except where indemnification is mandatory (*see ¶ 9:134*), a corporation organized under the General Corporation Law must determine that the agent acted in "good faith" (¶ 9:131), and must authorize the indemnification by appropriate board or shareholder action, by an opinion of independent legal counsel, or by court order. [Corps.C. § 317(e), ¶ 6:460 ff.]

The Social Purpose Corporations Act imposes no such requirements on SPCs, and it is not clear whether these General Corporation Law authorization requirements apply to SPCs (*see ¶ 9:121.1*).

➪ [9:137] ***PRACTICE POINTER:*** Prudence would suggest that the General Corporation Law should be followed here (per Corps.C. § 2501, ¶ 9:3); and the corporation should make a "good faith" determination and expressly authorize any indemnification.

[9:138 - 9:145] ***Reserved.***

2. [9:146] **Advancing Defense Costs:** An SPC may advance expenses, including attorney fees, incurred by a person in defending any "proceeding" (a threatened, pending or completed civil, criminal, administrative or investigative action or proceeding) prior to disposition of the proceeding. (Such advances are not considered officer or director "loans" requiring shareholder approval under Corps.C. § 315; *see discussion at* ¶ 6:471 ff.) [Corps.C. § 2702(a)(2), (3), (c)]

a. [9:147] **Repayment undertaking required?** A corporation organized under the General Corporation Law may make advances only if the recipient agrees to repayment in the event it is ultimately determined he or she is not entitled to indemnification. [See Corps.C. § 317(f); ¶ 6:465]

The Social Purpose Corporations Act requires no such repayment undertaking for advances by SPCs; and it is unclear whether the General Corporations Law's repayment undertaking applies to SPCs (*see ¶ 9:121.1*).

➪ [9:147.1] ***PRACTICE POINTER:*** Here again, the General Corporation Law should probably be followed (per Corps.C. § 2501, ¶ 9:3), and the corporation should obtain a repayment undertaking before advancing defense costs.

3. [9:148] **Liability Insurance:** An SPC may purchase and maintain insurance for any of its "agents" (directors, officers, employees or other agents, *see ¶ 9:123*) to the same extent as a corporation organized under the General Corporation Law. [Corps.C. § 2702(d); *see also* ¶ 6:466 ff.]

[9:149 - 9:160] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9-E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part I. Social Purpose Corporations

E. Shareholder Derivative Actions

1. [9:162] Action Strictly Limited to Shareholders
2. [9:163] Enforcement of SPC's Social Purpose
3. [9:164] Comment—Typos in Legislation

[9:161] SPC shareholders may bring derivative actions to the same extent and in the same manner as shareholders of corporations organized under the General Corporation Law. [Corps.C. § 2900]

However, Corps.C. § 2900, derived from and substantively identical to Corps.C. § 800, contains two provisions that have no counterpart in Corps.C. § 800:

1. [9:162] **Action Strictly Limited to Shareholders:** No derivative action against an SPC is permitted "by any party other than a shareholder of the social purpose corporation." [Corps.C. § 2900(c)]

This provision was likely intended to make clear that prospective or actual beneficiaries or recipients of the SPC's activities do not have standing to bring a derivative action.

2. [9:163] **Enforcement of SPC's Social Purpose:** SPC shareholders may maintain a derivative action to enforce the directors' duties to act in accordance with the SPC's prospects and purposes (per Corps.C. § 2700(c), ¶ 9:92). [Corps.C. § 2900(b)]

3. [9:164] **Comment—Typos in Legislation:** As stated (¶ 9:161), Corps.C. § 2900 is derived from Corps.C. § 800. In adding the above provisions unique to SPCs (¶ 9:162 ff.), the drafters neglected, in § 2900(g) and (h), to correct the reference to "subdivision (d)," which should read "subdivision (e)."

[9:165 - 9:169] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9-F

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part I. Social Purpose Corporations

F. Records and Reports

1. [9:171] Annual Report to Shareholders
   a. [9:172] Financial statements
      (1) [9:173] Accounting standards
         (a) [9:174] Compare—SPC with fewer than 100 shareholders
      (2) [9:176] Certification
      (3) [9:177] GCL compared—SPC "insider transactions" and indemnifications need not be set forth
      (4) [9:178] No waiver of annual report
   b. [9:186] Special purpose MD&A requirement
      (1) [9:187] Contents
         (a) [9:188] "Special purpose objectives"
   c. [9:189] When sent
      (1) [9:189.1] Comment—error in legislation; no waiver of annual report
   d. [9:190] Posting on Internet
   e. [9:191] Annual report upon shareholder request
   f. [9:194] Quarterly reports upon shareholder request
2. [9:201] Special Purpose Current Report
   a. [9:202] Posting on Internet
3. Limitations on Scope of Disclosures
   a. [9:211] Avoidance of unnecessary detail
   b. [9:212] Use of "best practices"
   c. [9:214] Disclosure prohibited by law
   d. [9:215] No liability for "forward-looking" statements
   e. [9:216] "Plain English" required
   f. [9:217] "Exemption" for publicly held companies
4. Enforcement by Shareholder's Suit
   a. [9:236] Injunction
   b. [9:238] Expenses
5. [9:239] Individual Liability for False Reports
6. [9:240] Application to Foreign SPCs
7. [9:241] Record Retention

[9:170] SPC reporting requirements are extensive and represent the most significant burden imposed on SPCs by the Social Purpose Corporations Act.

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

1. [9:171] **Annual Report to Shareholders:** An SPC must provide an annual report to its shareholders. [Corps.C. § 3500(a); see Corps.C. § 2503 (“annual report” defined)]

a. [9:172] **Financial statements:** The annual report must contain:

• A balance sheet as of the close of the fiscal year;

• An income statement for the fiscal year; and

• A statement of cash flows for the fiscal year. [Corps.C. § 3500(a)]

(1) [9:173] **Accounting standards:** SPC financial statements must be “prepared or determined in conformity with generally accepted accounting principles then applicable.” [Corps.C. § 114; *see* ¶ *6:547*]

(a) [9:174] **Compare—SPC with fewer than 100 shareholders:** As with the financial statements of corporations organized under the General Corporation Law and having fewer than 100 shareholders of record (Corps.C. § 1501(a)(3), ¶ 4:388, 6:548), the financial statements of SPCs having fewer than 100 shareholders of record (as determined under Corps.C. § 605) do *not* have to be prepared in conformity with generally accepted accounting principles … so long as they “reasonably set forth the assets and liabilities and the income and expense of the social purpose corporation and disclose the accounting basis used in their preparation.” [Corps.C. § 3502(g)]

[9:175] ***Reserved.***

(2) [9:176] **Certification:** The financial statements must be accompanied by “any report thereon of independent accountants” who prepared the statements. [Corps.C. § 3500(a)]

If there is no independent accountants' report, the financial statements must be accompanied by a certificate of an authorized officer of the SPC that the statements were prepared from the SPC's books and records without audit. [Corps.C. § 3500(a)]

(3) [9:177] **GCL compared—SPC “insider transactions” and indemnifications need not be set forth:** The annual report of a corporation organized under the General Corporation Law and having 100 or more shareholders must describe “insider transactions” of more than $40,000 and indemnification of more than $10,000 for any officer or director. [Corps.C. § 1501(b)(1) & (2); *see* ¶ *6:545 ff.*]

Although these additional reporting requirements are not expressly imposed on SPCs, they arguably apply to SPCs since SPCs remain subject to the General Corporation Law (Corps.C. § 2501, ¶ 9:3).

(4) [9:178] **No waiver of annual report:** *See* ¶ *9:189.1*.

[9:179 - 9:185] ***Reserved.***

b. [9:186] **Special purpose MD&A requirement:** The SPC's annual report must include a management discussion and analysis concerning the SPC's purpose or purposes stated in the articles (“special purpose MD&A”). [Corps.C. § 3500(b)]

(1) [9:187] **Contents:** The special purpose MD&A must include all of the following:

• Identification and discussion of the SPC's overall *objectives* relating to its special purpose or purposes, and identification and explanation of any *changes* in those “special purpose objectives” (*see* ¶ *9:188*) during the fiscal year. [Corps.C. § 3500(b)(1)]

• Identification and discussion of *“material” actions taken* by the SPC during the fiscal year to achieve its “special purpose objectives,” the impact of those actions (including the causal relationships between the actions and the reported outcomes), and the extent to which those actions achieved the “special purpose objectives” for the year. [Corps.C. § 3500(b)(2)]

• Identification and discussion of the *“material” actions*, including the intended impact of those actions, that the SPC *expects to take* in the short term and long term with respect to achievement of its “special purpose objectives.” [Corps.C. § 3500(b)(3)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• A description of the process for selecting, and an identification and description of, the *financial, operating and other measures* used by the SPC during the fiscal year for *evaluating its performance* in achieving its “special purpose objectives,” including an explanation and discussion of the nature and rationale for any material changes in those measures made during the fiscal year. [Corps.C. § 3500(b)(4)]

• Identification and discussion of any *“material” operating and capital expenditures* incurred during the fiscal year in furtherance of achieving the “special purpose objectives,” a “good faith estimate” of any additional “material” operating or capital expenditures the SPC *expects to incur over the next three fiscal years* in order to achieve its “special purpose objectives,” and *other “material” expenditures* of resources incurred during the fiscal year (including *employee time*) in furtherance of achieving the “special purpose objectives,” including a discussion of the extent to which that capital or use of other resources serves purposes *other than and in addition to* furthering the achievement of the “special purpose objectives.” [Corps.C. § 3500(b)(5)]

• Any other information that the SPC's officers and directors believe *reasonably necessary or appropriate* to an understanding of the SPC's efforts in connection with its special purpose or purposes. [Corps.C. § 3500(b)]

(a) [9:188] **“Special purpose objectives”:** This phrase means objectives set forth by management and the directors for purposes of measuring the impact of the SPC's efforts relating to its special purpose. [Corps.C. § 2516]

c. [9:189] **When sent:** The annual report, including the special purpose MD&A, must be sent to the shareholders at least *15 days* (or if sent by bulk mail, *35 days*) prior to the annual meeting of shareholders to be held during the fiscal year immediately following the fiscal year covered by the annual report. [Corps.C. § 3500(c)]

(1) [9:189.1] **Comment—error in legislation; no waiver of annual report:** Corps.C. § 3500(c) requires the annual report to be sent out “[e]xcept as may otherwise be excused pursuant to subdivision (h) of Section 1501.5.” There is no Corps.C. § 1501.5. This was probably intended to be a reference to what was then Corps.C. § 3502(h), which permitted corporations having unrevoked waivers from holders of at least two-thirds of the outstanding shares to dispense with the *current report* (¶ 9:201) and, if read literally, the *special purpose MD&A* (but the literal language could have been a drafting error and the waiver may have been intended to apply to the entire annual report). In any event, this version of Corps.C. § 3502(h) was *repealed* effective January 1, 2015.

Currently, there is no provision in the Social Purpose Corporations Act permitting waiver of the annual report or the special purpose current report (¶ 9:201). Arguably, Corps.C. § 2501, which applies the General Corporation Law to SPCs “[e]xcept as otherwise expressly stated” (*see ¶ 9:3*), could permit an SPC with fewer than 100 shareholders to adopt a bylaw provision waiving the annual report pursuant to Corps.C. § 1501(a)(1) (¶ 4:389, 6:540). However, the SPC report requirements contained in Corps.C. §§ 3500-3503 are comprehensive and generally parallel the annual report requirements under the General Corporation Law—with the notable absence of a waiver provision comparable to Corps.C. § 1501(a)(1). A comparable waiver provision could easily have been included in the Social Purpose Corporations Act. The fact that it was not included—and that a somewhat similar waiver provision was originally included but subsequently repealed—strongly argues against the applicability of the Corps.C. § 1501(a)(1) waiver provision to SPCs.

d. [9:190] **Posting on Internet:** In addition to being sent to the shareholders, the special purpose MD&A must, to the extent consistent with reasonable confidentiality requirements, be made *publicly available* by posting on the SPC's website “or providing it through similar electronic means.” [Corps.C. § 3500(b)]

e. [9:191] **Annual report upon shareholder request:** If the SPC failed to send an annual report to its shareholders, the report must be furnished upon request of any shareholder. [Corps.C. § 3500(d)]

The request must be in writing and made more than *120 days* after the close of the fiscal year. The SPC must deliver or mail to the person making the request the annual report together with the special purpose MD&A (¶ 9:186) within 30 days after receipt of the request. [Corps.C. § 3500(d)]

[9:192 - 9:193] ***Reserved.***

f. [9:194] **Quarterly reports upon shareholder request:** Shareholders with *5% or more* of *any class* of shares may obtain *interim* (quarterly) financial reports. [Corps.C. § 3500(e)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Upon written request, such shareholders are entitled to income statements and balance sheets for the preceding three-month, six-month or nine-month period, accompanied by the same sort of accountant's report or officer's certification as required for the annual report (¶ 9:173 ff.). These interim reports must be delivered or mailed to the requesting shareholders within 30 days after the request. In addition, copies must be kept at the SPC's principal office and made available to any other shareholder who requests them. [Corps.C. § 3500(e)]

[9:195 - 9:200] ***Reserved.***

2. [9:201] **Special Purpose Current Report:** In addition to the annual report, a "special purpose current report" must be sent to the SPC shareholders. The special purpose current report must be sent not later than *45 days* after the occurrence of, and must identify and discuss in reasonable detail (unless previously reported in the most recent annual report), the following:

• Any *expenditure* or group of related or planned expenditures (*excluding* officer and director compensation) likely to have a "material adverse impact" on the results of operations or financial condition for a quarterly or annual fiscal period and made in furtherance of the "special purpose objectives" (¶ 9:188), whether an operating expenditure, capital expenditure or some other expenditure of corporate resources (*including* employee time), whether direct or indirect, and whether categorized as overhead or otherwise. [Corps.C. § 3501(a), (b)]

• Any decision by the board or action by management to:

— *Withhold expenditures* or a group of related or planned expenditures, whether temporarily or permanently, that were to be made in furtherance of the special purpose as contemplated in the most recent annual report, whether those planned expenditures were an operating expenditure, capital expenditure or some other expenditure of corporate resources (*including* employee time), whether direct or indirect, and whether categorized as overhead or otherwise, in any case where the planned expenditure was likely to have a *material positive impact* on the SPC's "special purpose objectives" (¶ 9:188) as contemplated in the most recent annual report; or

— Determine that the SPC's *special purpose has been satisfied or should no longer be pursued*, whether temporarily or permanently. [Corps.C. § 3500(a), (c)(1) & (2)]

a. [9:202] **Posting on Internet:** In addition to being sent to shareholders, the special purpose current report must, to the extent consistent with reasonable confidentiality requirements, be made publicly available by posting it on the SPC's website "or providing it through similar electronic means." [Corps.C. § 3501(a)]

[9:203 - 9:210] ***Reserved.***

3. Limitations on Scope of Disclosures

a. [9:211] **Avoidance of unnecessary detail:** The special purpose MD&A (¶ 9:186) and the special purpose current report (¶ 9:201) need not itemize every relevant expenditure or detail every action taken or planned by the SPC. Management and the board may use their discretion in providing information, including the amount of detail that a *reasonable investor would consider important* in understanding the SPC's "objectives, actions, impacts, measures, rationale, and results of operations" as they relate to the SPC's "special purpose objectives" (¶ 9:188). [Corps.C. § 3502(a)]

b. [9:212] **Use of "best practices":** Where "best practices" emerge for providing the special purpose MD&A and special purpose current reports, use of those best practices creates a *presumption* that the SPC provided all required information. The presumption can be rebutted only by showing that the report(s) *misstated or omitted a material fact*. [Corps.C. § 3502(b)]

➪ [9:213] ***PRACTICE POINTER:*** "Best practices" is a novel and evolving concept. Although no generally accepted "best practices" have yet emerged, the nonprofit organization B Lab sets forth specific requirements when granting "benefit corporation certification" (*see* ¶ *9:500, 9:503.1*).

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

c. [9:214] **Disclosure prohibited by law:** No disclosure is required in the special purpose MD&A or special purpose current report that would result in a violation of state or federal securities or other applicable laws. [Corps.C. § 3502(c)]

d. [9:215] **No liability for "forward-looking" statements:** Neither the SPC nor its officers or directors are liable for forward-looking statements (as that term is used in the federal securities laws, *see ¶ 6:370c*) supplied in "good faith" in the special purpose MD&A or special purpose current report. [Corps.C. § 3502(d)]

e. [9:216] **"Plain English" required:** The special purpose MD&A and special purpose current report must be written in "plain English" and in an efficient and understandable manner, and must also avoid repetition and disclosure of immaterial information. [Corps.C. § 3502(e)]

f. [9:217] **"Exemption" for publicly held companies:** The SPC reporting requirements do not apply to an SPC that is a 1934 Act reporting company so long as (1) the SPC furnishes annual and quarterly reports in accordance with federal securities laws and (2) the annual report includes the special purpose MD&A and the quarterly reports include the information required by the special purpose current report. [Corps.C. § 3502(h), (i)]

[9:218 - 9:235] ***Reserved.***

4. Enforcement by Shareholder's Suit

a. [9:236] **Injunction:** A shareholder may sue in the appropriate superior court for an injunction to compel the SPC to prepare and furnish the annual and special purpose current reports. (The court may extend the SPC's time to provide such information if the SPC shows "good cause.") [Corps.C. § 3502(j); *see ¶ 6:554*]

[9:237] ***Reserved.***

b. [9:238] **Expenses:** In such suits, courts may award shareholders their litigation expenses, including attorney fees, if they find that an SPC's failure to comply was "without justification." [Corps.C. § 3502(k); *see ¶ 6:555*]

5. [9:239] **Individual Liability for False Reports:** The liability of SPC officers, directors, employees and agents for knowingly false statements in records and reports is the same as the liability imposed under the General Corporation Law. Such liability also extends to the annual report (¶ 9:171) and special purpose current report (¶ 9:201). [Corps.C. § 3503(a)-(c); *see ¶ 6:253.1*]

In addition, with respect to the special purpose MD&A and the current report, SPC officers, directors, employees and agents may be liable for any knowing *omission* of a material fact necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading in a material respect. [Corps.C. § 3503(d)]

6. [9:240] **Application to Foreign SPCs:** The annual report requirement (¶ 9:171) and the special purpose current report requirement (¶ 9:201) apply to a foreign SPC having its principal office in California or "customarily holding" board meetings here. [Corps.C. § 3502(*l*)]

7. [9:241] **Record Retention:** The SPC must maintain all annual and special purpose current reports in electronic form for at least 10 years. [Corps.C. § 3502(m)]

[9:242 - 9:260] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9-G

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part I. Social Purpose Corporations

G. Amendment of Articles

1. [9:262] Change in Special Purpose
2. [9:263] Change of Status to Nonprofit or Cooperative Corporation
   a. Change of status to nonprofit corporation
      (1) [9:264] Required provisions in amendment
      (2) [9:265] Shareholder approval requirement
         (a) [9:266] Exception—mutual water company SPC
   b. Change of status to cooperative corporation
      (1) [9:271] Required provisions in amendment
      (2) [9:272] Shareholder approval requirement
   c. [9:273] Status change by merger
   d. [9:274] Dissenters' rights
3. [9:276] Change of Status to "Business Corporation"
   a. [9:277] "Business corporation"
      (1) [9:278] Benefit corporation?
   b. [9:279] Statement of purpose and SPC references deleted
   c. [9:280] Two-thirds shareholder approval required
      (1) [9:281] Dissenters' rights
   d. [9:282] Status change by merger

[9:261] The procedure for amendment of an SPC's articles of incorporation is the same as for amendment of the articles of a corporation organized under the General Corporation Law (*see ¶ 8:2 ff.*), *except* as set forth below (¶ 9:263 ff.). [See Corps.C. § 2501]

1. [9:262] **Change in Special Purpose:** An amendment that would *materially alter* any special purpose of the SPC stated in its articles must be approved by at least *two-thirds* of the outstanding shares (or any greater amount required by the articles) of each class regardless of whether that class is otherwise entitled to vote on the amendment. [Corps.C. § 3000(b)]

2. [9:263] **Change of Status to Nonprofit or Cooperative Corporation:** An SPC may use the vehicle of an articles amendment to change its status to a nonprofit public benefit corporation, nonprofit mutual benefit corporation, nonprofit religious corporation, or cooperative corporation. [Corps.C. § 3001(a)]

a. Change of status to nonprofit corporation

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [9:264] **Required provisions in amendment:** An amendment to change the SPC's status to a nonprofit corporation must:

— revise the statement of purpose;

— delete the authorization for shares and any other provisions relating to shares;

— if shares have been issued, provide either for the cancellation of those shares or for their conversion into nonprofit corporation memberships; and

— make other changes as may be necessary or desired. [Corps.C. § 3001(b)]

(2) [9:265] **Shareholder approval requirement:** If shares have been issued, the amendment must be approved by *all* of the outstanding shares of all classes regardless of limitations or restrictions on their voting rights. [Corps.C. § 3001(c)]

(a) [9:266] **Exception—mutual water company SPC:** If the SPC is a mutual water company (Pub.Util.C. § 2705) and under the terms of the status change each outstanding share is converted into a membership of a *nonprofit mutual benefit corporation*, the amendment must be approved by a *majority* (or greater number if required by the articles) of the outstanding shares of each class regardless of limitations or restrictions on their voting rights. [Corps.C. § 3001(e); see Corps.C. § 152]

[9:267 - 9:270] ***Reserved.***

b. Change of status to cooperative corporation

(1) [9:271] **Required provisions in amendment:** An amendment to change the SPC's status to a cooperative corporation must:

— revise the statement of purpose;

— if shares have been issued, provide for the cancellation of those shares or their conversion to cooperative corporation memberships; and

— make other changes as may be necessary or desired. [Corps.C. § 3001(b)]

(2) [9:272] **Shareholder approval requirement:** The amendment must be approved by the affirmative vote of a *majority* (or greater number if required by the articles) of the outstanding shares of each class regardless of limitations or restrictions on their voting rights. [Corps.C. § 3001(c); see Corps.C. § 152]

c. [9:273] **Status change by merger:** If the articles amendment is included in a merger agreement, any provision for cancellation of shares must be in the merger agreement rather than in the articles amendment. [Corps.C. § 3001(d)]

d. [9:274] **Dissenters' rights:** Dissenters' rights apply when an SPC *merges* into a cooperative corporation. [Corps.C. § 3201; *see ¶ 9:313.1*]

It would appear that dissenters' rights do *not* apply in a change in status to a cooperative corporation … because Corps.C. § 3001 does not provide for dissenters' rights. (Although some unofficial versions of Corps.C. § 3001 are captioned “Conversion to nonprofit or cooperative corporations,” and conversions may entail dissenters' rights (¶ 9:323), the caption is not part of the official Corporations Code.) [See Corps.C. § 3001; compare Corps.C. § 3002—dissenters' rights apply in change of status from SPC to “business corporation,” ¶ 9:281]

It is admittedly anomalous that dissenters' rights apply in a *merger* with, but not to a change in status to, a surviving cooperative corporation. It is not known whether the anomaly is intentional or the result of a legislative oversight or drafting error.

[9:275] ***Reserved.***

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

3. [9:276] **Change of Status to “Business Corporation”:** An SPC may use the vehicle of an articles amendment to change its status to a “business corporation.” [Corps.C. § 3002(a)]

a. [9:277] **“Business corporation”:** Neither the Social Purpose Corporations Act nor the General Corporation Law defines “business corporation.” The Nonprofit Corporation Law (Corps.C. § 5000 et seq.) defines “business corporation” as a corporation formed or existing under the General Corporation Law. [Corps.C. § 5039; see Corps.C. § 162]

For Corps.C. § 3002(a) purposes, “business corporation” is probably intended to have the same meaning as used in § 5039—i.e., a corporation formed under the General Corporation Law.

(1) [9:278] **Benefit corporation?** It is not entirely clear whether “business corporation” includes a benefit corporation. However, Corps.C. § 14600(c) provides that the General Corporation Law applies to benefit corporations except when the provisions of the General Corporation Law conflict or are inconsistent with the law applicable to benefit corporations (*see ¶ 9:500*). And Corps.C. § 14600(b) refers to “a business corporation that is not a benefit corporation,” thus implying that a “business corporation” includes a benefit corporation. Thus, it would appear that an SPC can amend its articles to change its status to a benefit corporation.

In any event, a nonSPC corporation can become a benefit corporation by an articles amendment (Corps.C. § 14610(b), (d), ¶ 9:531), and it would be a needless formality to require an SPC to first amend its articles to change its status to a “business corporation” and then amend the articles again to effect a change of status to a benefit corporation.

b. [9:279] **Statement of purpose and SPC references deleted:** The amendment must delete the provisions unique to SPCs:

— “social purpose corporation” or the abbreviation thereof that appears in the corporate name (¶ 9:22);

— the SPC purpose statement or statements (¶ 9:23 ff.); and

— the statement that the SPC is organized as a social purpose corporation (¶ 9:25) or a close social purpose corporation (¶ 9:28), as the case may be. [See Corps.C. § 3002(b)]

c. [9:280] **Two-thirds shareholder approval required:** If the SPC issued shares, the amendment must be approved by the affirmative vote of at least two-thirds (or any greater number required by the articles) of the outstanding shares of each class regardless of whether that class is otherwise entitled to vote thereon. [Corps.C. § 3002(c)]

(1) [9:281] **Dissenters' rights:** If the status change is approved, SPC shareholders with “dissenting shares” have the full dissenters' rights set forth in the General Corporation Law (*see ¶ 8:292 ff.*). [Corps.C. §§ 3002(c), 3305]

d. [9:282] **Status change by merger:** If the amendment is included in a merger agreement, any provision for cancellation or conversion of shares must be in the merger agreement rather than in the articles. [Corps.C. § 3002(d)]

[9:283 - 9:300] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9-H

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part I. Social Purpose Corporations

H. Sale of Assets

- 1. [9:302] Two-Thirds Shareholder Approval Required
  - a. [9:303] 90% approval required if purchaser and seller under common control
    - (1) [9:304] Comment re "other business entity"
  - b. [9:305] No exception for sale in ordinary course of business
- 2. [9:306] Compare—Sale-of-Assets Reorganization
  - a. [9:307] 90% approval required if purchaser and seller under common control

[9:301] SPCs may sell all or substantially all of their assets by following the same procedures applicable to corporations organized under the General Corporation Law, except as set forth below (¶ 9:302 ff.). [See Corps.C. §§ 2501, 3100; *and* ¶ *8:581 ff.*]

1. [9:302] **Two-Thirds Shareholder Approval Required:** An SPC may sell all or substantially all of its assets upon approval of at least *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class, *regardless of whether the articles entitle that class to vote on the transaction*. (In contrast, a corporation organized under the General Corporation Law may sell all or substantially all of its assets upon approval of a *majority* of the shares *entitled to vote*; *see* ¶ *8:589*.) [Corps.C. § 3100(a)]

a. [9:303] **90% approval required if purchaser and seller under common control:** Where the seller-SPC is controlled by the purchaser, or they are commonly controlled (i.e., not an "arm's-length" transaction), the principal terms of the sale must be approved by at least *90%* of the voting shares of the seller-SPC … *unless* the purchaser is an "other business entity" (¶ 9:304) or SPC whose articles of incorporation specify *materially the same purposes* as the seller-SPC *and* the assets are sold solely for the purchaser's or its parent's nonredeemable common stock (or nonredeemable equity securities where the issuer is a noncorporate entity). (But 90% shareholder approval is not required where the Financial Protection and Innovation Commissioner (formerly the Business Oversight Commissioner) approves the terms and conditions and "fairness" of the sale.) [Corps.C. § 3100(d), (e); *see* ¶ *8:590 ff.*]

(1) [9:304] **Comment re "other business entity":** "Other business entity" can include a limited liability company, limited or general partnership, business trust or other entity that does not have articles of incorporation. [Corps.C. § 174.5]

In such circumstances, the 90%-approval requirement could probably be avoided where the entity's *charter documents* set forth purposes "materially the same" as the seller-SPC's purposes.

b. [9:305] **No exception for sale in ordinary course of business:** A corporation organized under the General Corporation Law need not obtain the approval of its shareholders for a sale of all or substantially all of its assets in the "usual and regular course of its business." [Corps.C. § 1001(a); *see* ¶ *8:593*]

There is *no comparable exception* for an SPC.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

2. [9:306] **Compare—Sale-of-Assets Reorganization:** An SPC's sale-of-assets *reorganization* is *not* governed by Corps.C. § 3100 (¶ 9:302 ff.). Rather, the transaction is governed by the reorganization provisions of the General Corporation Law (Corps.C. § 1200 et seq., ¶ 8:259 ff.) and the reorganization provisions of the Social Purpose Corporations Act (Corps.C. § 3400 et seq., ¶ 9:311 ff.). [Corps.C. § 3100(a); see Corps.C. § 2511(c) ("sale of assets reorganization" defined)]

a. [9:307] **90% approval required if purchaser and seller under common control:** However, the 90%-shareholder-approval provision of Corps.C. § 3100(d) (¶ 9:303) still applies where the seller-SPC is controlled by the purchaser (or they are commonly controlled) and the purchaser does not have the same purposes as the SPC. [Corps.C. § 3100(a); *see* ¶ *8:270 ff.*]

[9:308 - 9:310] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9-I

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part I. Social Purpose Corporations

I. Reorganizations

1. [9:312] Mergers
  a. [9:313] Two-thirds shareholder approval required
    (1) [9:313.1] Dissenters' rights
    (2) [9:314] Exception—merger with nonprofit corporation
2. [9:315] Exchange Reorganizations (Stock-for-Stock) and Sale-of-Assets Reorganizations

[9:311] The reorganization provisions of the Social Purpose Corporations Act generally parallel the reorganization provisions of the General Corporation Law.

1. [9:312] **Mergers:** SPCs can merge with other domestic or foreign SPCs and with other domestic or foreign entities, such as corporations organized under the General Corporation Law, nonprofit corporations, limited partnerships, limited liability companies or business trusts. Mergers involving SPCs are effected by following the same procedures applicable to corporations organized under the General Corporation Law (*see ¶ 8:161 ff.*), *except* as set forth at ¶ 9:313 ff. or 8:161 ff. [See Corps.C. § 3200 et seq.]

a. [9:313] **Two-thirds shareholder approval required:** Where the surviving entity is not an SPC, or is an SPC whose articles of incorporation set forth "materially different purposes" than the disappearing SPC's articles, the merger must be approved by the affirmative vote of at least *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class, regardless of whether the articles entitle that class to vote on the transaction. (In contrast, a merger of corporations organized under the General Corporation Law generally requires approval of only a *majority* of the corporations' shares; *see ¶ 8:173 ff.*) [Corps.C. § 3201]

(1) [9:313.1] **Dissenters' rights:** If the merger is approved, SPC shareholders with "dissenting shares" have the full dissenters' rights set forth in the General Corporation Law (*see ¶ 8:292 ff.*). [Corps.C. § 3201]

(2) [9:314] **Exception—merger with nonprofit corporation:** A merger into a nonprofit public benefit corporation, nonprofit mutual benefit corporation or nonprofit religious corporation must be approved by *all* the outstanding shares of all classes of the SPC regardless of limitations or restrictions on their voting rights. [Corps.C. § 3202]

2. [9:315] **Exchange Reorganizations (Stock-for-Stock) and Sale-of-Assets Reorganizations:** An SPC may engage in an exchange reorganization, "share exchange tender offer" or "sale-of-assets reorganization" by following the same procedures applicable to corporations organized under the General Corporation Law, except as set forth at ¶ 8:235 ff. [See Corps.C. §§ 2511(b) ("exchange reorganization" defined), (c) ("sale of assets reorganization" defined), 2512 ("share exchange tender offer" defined)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[9:316 - 9:320] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9-J

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part I. Social Purpose Corporations

J. Conversions

1. [9:322] Two-Thirds Shareholder Approval Required
  a. [9:323] Dissenters' rights
2. [9:324] Compare—Change of Status Into Other Type of Corporation

[9:321] An SPC can convert into another *domestic* business entity (general partnership, limited partnership or limited liability company) by following the same procedures applicable to conversions of corporations organized under the General Corporation Law (*see ¶ 8:451 ff.*), *except* as set forth at ¶ 9:322 ff. or 8:451 ff. [See Corps.C. § 3300 et seq.]

1. [9:322] **Two-Thirds Shareholder Approval Required:** Conversion of an SPC into another entity must be approved by the affirmative vote of at least *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class, regardless of whether the articles entitle that class to vote on the transaction. (In contrast, conversion of a corporation organized under the General Corporation Law into another entity generally requires approval of only a *majority* of the shares; *see ¶ 8:471 ff.*) [Corps.C. §§ 3301(a)(2), 3302(b)]
   a. [9:323] **Dissenters' rights:** If the plan is approved, SPC shareholders with "dissenting shares" have the full dissenters' rights set forth in the General Corporation Law (*see ¶ 8:292 ff.*) [Corps.C. §§ 3302(b), 3305]

2. [9:324] **Compare—Change of Status Into Other Type of Corporation:** A "conversion" into a nonprofit or "business" corporation is a change of status effected by way of an articles amendment (or merger); *see ¶ 9:263 ff.*

[9:325 - 9:499] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9(II)-A

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part II. Benefit Corporations

A. Introduction and Background

1. [9:501] "General Public Benefit" Requirement
2. [9:502] Reasons for Benefit Corporation Legislation
3. [9:503] Relationship to Social Purpose Corporations
    a. [9:503.1] "Benefit corporation certification"; benefit corporation's advantage over SPC
4. [9:504] Taxed as Corporation
    a. [9:504.1] Compare—nonprofit "public benefit corporation"
5. [9:505] Corporate Powers Subject to Benefit Purposes

[9:500] A benefit corporation is a *for-profit* corporation organized under the General Corporation Law that elects to become subject to Corporations Code Title 1, Division 3, Part 13 (Corps.C. §§ 14600-14631). [Corps.C. § 14600(a)]

The provisions of the General Corporation Law (Corps.C. § 100 et seq.) continue to apply to benefit corporations "except where those provisions are in conflict with or inconsistent with" Corps.C. § 14600 et seq. [Corps.C. § 14600(c)]

California follows the trend of enacting "benefit corporation" laws in other states. According to the nonprofit organization B Lab, at least 44 states, the District of Columbia and Puerto Rico have passed "benefit corporation" legislation. This and other information regarding "benefit corporations" can be found on B Lab's website (*www.bcorporation.net*).

[9:500.1] **Secretary of State Filing Data:** For data from the Secretary of State on the number of benefit corporations organized in California for the years 2012-2021, *see ¶ 9:1.1*.

1. [9:501] **"General Public Benefit" Requirement:** A benefit corporation must have the purpose of creating a "general public benefit"—i.e., "a *material positive impact* on *society and the environment*, taken as a whole, as assessed against a third-party standard" (*see ¶ 9:604 ff.*). The creation of this general public benefit, and any specific public benefit (*¶ 9:523*), is deemed to be in the corporation's best interests. [Corps.C. §§ 14601(c) (emphasis added), 14610(a), (c)]

2. [9:502] **Reasons for Benefit Corporation Legislation:** Prior to 2012, the General Corporation Law lacked a framework for corporations to organize and operate for a public benefit purpose greater than simply pursuing profit or a narrow objective of corporate social responsibility. The proponents of the benefit corporation legislation envisioned building a new sector of the economy that uses the power of business to solve social and environmental problems. The benefit corporation framework provides "an alternative corporate structure with higher standards of corporate purpose, accountability, and transparency." It was created for entrepreneurs and investors who want to build businesses "with an eye toward the triple bottom line of people, planet, and profit." [Assembly Judiciary Committee Analysis of AB 361 (5/2/11); Senate Banking & Financial Institutions Committee Analysis of AB 361 (6/24/11)]

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

3. [9:503] **Relationship to Social Purpose Corporations:** In California, benefit corporations and social purpose corporations (SPCs, ¶ 9:1 ff.) grew out of competing proposals.

During the drafting of the 2011 legislative bill that created SPCs, a number of persons became dissatisfied with the bill's provisions, and proposed the benefit corporation as an alternative. Although the respective proponents tried to persuade the Legislature that two discrete types of for-profit "public benefit" corporations would result in confusion, both types were ultimately enacted.

In contrast to the number of states that have authorized "benefit corporations" (*see ¶ 9:500*), only a handful of states have authorized "social purpose corporations."

a. [9:503.1] **"Benefit corporation certification"; benefit corporation's advantage over SPC:** California benefit corporations sometimes seek "benefit corporation certification" from an independent organization, such as B Lab (¶ 9:500). Certification from B Lab authorizes the corporation to use the B circle mark logo.

A California SPC, like "social purpose corporations" in other states, is not required to pursue a *general* public benefit (*see ¶ 9:501*) but, rather, is required only to pursue one or more charitable or public purposes that it specifies in its articles (*see ¶ 9:24*). An SPC seeking "benefit corporation certification" may need to include in its articles an express commitment to pursue a material positive impact on society and the environment as a whole. Other articles provisions may also be needed (see *https://bcorporation.net*).

4. [9:504] **Taxed as Corporation:** Although a benefit corporation may combine public benefit with profit-making objectives, it has no special tax benefits: A benefit corporation is taxed as a for-profit corporation under both federal and California tax law. (But a benefit corporation may elect to be taxed as an S corporation; *see ¶ 2:119 ff., 4:480 ff.*)

a. [9:504.1] **Compare—nonprofit "public benefit corporation":** A benefit corporation should not be confused with a nonprofit "public benefit corporation," which, as the name implies, is a specific type of *nonprofit* corporation and is governed by the Nonprofit Public Benefit Corporation Law (Corps.C. § 5110 et seq.).

5. [9:505] **Corporate Powers Subject to Benefit Purposes:** A benefit corporation may engage in any business activity, subject to any limitation contained in its articles and compliance with applicable laws, *and subject to the corporation's purpose of creating a general public benefit* (*see ¶ 9:501*) *and any specific public benefit purposes* set forth in its articles (*¶ 9:523*). [Corps.C. § 14610(a)]

[9:506 - 9:520] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9(II)-B

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part II. Benefit Corporations

B. Formation

1. [9:521] Articles of Incorporation—Benefit Provision Required
  a. [9:523] Specific public benefits
  b. [9:524] General public benefit paramount
    (1) [9:525] Comment
2. [9:531] Formation by Articles Amendment
  a. [9:532] Exchange reorganization
  b. [9:533] Shareholder approval
  c. [9:534] Dissenters' rights
3. [9:535] Formation by Merger or Conversion
  a. [9:536] Two-thirds approval required
    (1) "Minimum status vote"
      (a) [9:537] Corporation
      (b) [9:538] Domestic "other business entity"
        1) [9:539] Additional voting requirements imposed by law or charter documents
4. [9:540] Legend Requirement on Stock Certificates

1. [9:521] **Articles of Incorporation—Benefit Provision Required:** The procedure for forming a benefit corporation is the same as for other corporations organized under the General Corporation Law (Corps.C. § 200 et seq.; *see Chs. 3 & 4*), except that the articles of a benefit corporation must state, "This corporation is a benefit corporation." The articles must also identify any "specific public benefit" (*¶ 9:523*) adopted by the corporation. [Corps.C. §§ 14602, 14610(b); see Corps.C. § 206]

➪ [9:522] ***PRACTICE POINTER:*** The articles need not state that the corporation has the purpose of creating a "general public benefit" (*¶ 9:501*).

a. [9:523] **Specific public benefits:** A "specific public benefit" includes:

- Providing low-income or underserved individuals or communities with beneficial products or services;
- Promoting economic opportunity for individuals or communities beyond the creation of jobs in the ordinary course of business;
- Preserving the environment;
- Improving human health;
- Promoting the arts, sciences or advancement of knowledge;

WESTLAW © 2025 Thomson Reuters. No claim to original U.S. Government Works.

• Increasing capital flow to entities with a public benefit purpose; and

• Any other particular benefit for society or the environment. [Corps.C. § 14601(e)]

b. [9:524] **General public benefit paramount:** Any specific public benefits set forth in the articles do not limit the benefit corporation's obligation to create a general public benefit (*¶ 9:501*). [Corps.C. § 14610(b)]

(1) [9:525] **Comment:** It is unclear why a "specific public benefit" (*¶ 9:523*) does not ipso facto constitute a "general public benefit" (*¶ 9:501*).

[9:526 - 9:530] ***Reserved.***

2. [9:531] **Formation by Articles Amendment:** A corporation that is not a benefit corporation may become a benefit corporation by amending its articles to contain the statement, "This corporation is a benefit corporation." [Corps.C. §§ 14603(a), 14610(b), (d); *see ¶ 9:521*]

a. [9:532] **Exchange reorganization:** A corporation that is not a benefit corporation may become a benefit corporation by engaging in an "exchange reorganization" (*¶ 8:235 ff.*) in which the acquired corporation simultaneously amends its articles to provide that it will be a benefit corporation. [Corps.C. § 14603(b)]

b. [9:533] **Shareholder approval:** The amendment (or reorganization, ¶ 9:532) must be adopted by at least the "minimum status vote" (*¶ 9:537 ff.*). [Corps.C. § 14603(a)]

c. [9:534] **Dissenters' rights:** Holders of "dissenting shares" (see Corps.C. § 1300(b)) have the full dissenters' rights set forth in the General Corporation Law (Corps.C. § 1300 et seq.; *see ¶ 8:292 ff.*). [Corps.C. § 14603(a)]

3. [9:535] **Formation by Merger or Conversion:** A corporation that is not a benefit corporation may merge into a benefit corporation. And a domestic "other business entity" (i.e., a noncorporate entity; see Corps.C. §§ 167.7, 174.5) may merge or convert into a benefit corporation. [Corps.C. § 14603(b), (c)]

a. [9:536] **Two-thirds approval required:** The merger or conversion must be approved by at least the "minimum status vote." [Corps.C. § 14603(b)-(d)]

(1) "Minimum status vote"

(a) [9:537] **Corporation:** In the case of a corporation, the "minimum status vote" means *two-thirds* (or any greater amount required by the articles) of the outstanding shares of each class or series of stock *regardless of any limitation stated in the articles or bylaws on the voting rights of any class or series*. This is in addition to any other vote or approval that may be required by the General Corporation Law. [Corps.C. § 14601(d)(1)]

(b) [9:538] **Domestic "other business entity":** In the case of a domestic "other business entity," the "minimum status vote" means *two-thirds* of every class or series of interest entitled to receive a *distribution* of any kind from the entity *regardless of any otherwise applicable limitation on the voting rights of the interest*. [Corps.C. § 14601(d)(2)]

1) [9:539] **Additional voting requirements imposed by law or charter documents:** The two-thirds approval is in addition to any other approval, vote or consent required by (i) the statutory law that principally governs the internal affairs of the entity, (ii) any provision of the publicly filed record or document required to form the entity, or (iii) any agreement binding some of the holders of equity interests in the entity. [Corps.C. § 14601(d)(2)]

Moreover, approval by *more than two-thirds* must be obtained if any of these publicly filed records or documents, or agreement among equity holders, so requires. [Corps.C. § 14601(d)(2)(B) (reference to entity's "articles of incorporation" is drafting error)]

4. [9:540] **Legend Requirement on Stock Certificates:** The certificates representing benefit corporation shares must include the following *conspicuous* language on the *face* of the certificate:

"This entity is a benefit corporation organized under Part 13 (commencing with Section 14600) of Division 3 of Title 1 of the California Corporations Code." [Corps.C. § 14631]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

[9:541 - 9:550] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9(II)-C

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part II. Benefit Corporations

C. Directors' and Officers' Duties

1. [9:552] Elimination of "Shareholder Primacy"
   a. [9:553] Other "constituencies"/interests
   b. [9:554] Relevant considerations
   c. [9:555] No particular consideration or beneficiary need be given priority
   d. [9:556] Applicable to officers
2. [9:559] No Fiduciary Duty to Beneficiaries
3. [9:560] Reliance Upon Officers and Experts
4. [9:561] No Monetary Liability Under Benefit Corporation Law
5. [9:581] Application to Foreign Corporations
6. [9:582] Benefit Enforcement Proceedings
   a. [9:583] Basis for proceeding
   b. [9:584] Damages limitation
   c. [9:586] Potential attorney fees award to prevailing plaintiff

[9:551] The duties of a director of a benefit corporation echo, but vary significantly from, the duties of directors of other for-profit corporations. And the duties of benefit corporation *directors* can apply to benefit corporation *officers*.

1. [9:552] **Elimination of "Shareholder Primacy":** Directors of other for-profit corporations (including SPCs, *see ¶ 9:82*) must perform their duties in "good faith," in a manner the director believes to be in the best interests of the corporation *and its shareholders*, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. [Corps.C. § 309(a); see Corps.C. § 2700(a) (SPCs)]

A benefit corporation director has identical obligations to act "in a manner the director believes to be in the best interests of the benefit corporation …" However, the reference to the *shareholders* is eliminated. [Corps.C. § 14620(a)]

a. [9:553] **Other "constituencies"/interests:** In discharging their duties, the directors "shall" consider the impacts of any action or proposed action upon:

- The *shareholders;*
- The *employees and workforce* of the corporation, its subsidiaries *and suppliers;*
- The interests of *customers* as beneficiaries of the corporation's general or specific public benefit purposes;
- *Community and societal considerations*, including those of any community in which offices or facilities of the corporation, its subsidiaries or *suppliers* are located;

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

- The *local and global environment;*

- The corporation's *short-term and long-term interests*, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by *retaining control* of the corporation rather than selling or transferring control to another entity*; and*

- The corporation's ability to accomplish its general, and any specific, *public benefit purpose*. [Corps.C. § 14620(b); *see* ¶ *9:605*]

b. [9:554] **Relevant considerations:** In discharging their duties, the directors *may* consider:

- The resources, intent and conduct, including past, stated and potential conduct, of *any person seeking control* of the benefit corporation; and

- Any other pertinent factors or the interests of *any other person or group*. [Corps.C. § 14620(c)]

c. [9:555] **No particular consideration or beneficiary need be given priority:** The directors are not required to give priority to any particular factor or the interests of any particular person or group *unless* the articles state an intention to give priority to a specific public benefit purpose. [Corps.C. § 14620(d)]

d. [9:556] **Applicable to officers:** The interests and factors that a benefit corporation *director* must consider (¶ 9:552 ff.) must likewise be considered by a benefit corporation *officer* when:

- The officer has *discretion to act* with respect to a matter; or

- It reasonably appears to the officer that the matter *may have a material effect* on those interests and factors or on the creation of a general or specific public benefit by the benefit corporation. [Corps.C. § 14622(a)]

  Consideration of these interests and factors does not violate the officer's duties to the benefit corporation. [Corps.C. § 14622(b)]

  ➪ [9:557] ***PRACTICE POINTER:*** There is no statutory requirement that officers make a record of their considerations when taking actions that impact the corporation's public benefit interests or purposes. While there is likewise no statutory record requirement with respect to *directors*, a record of directors' considerations is generally made in the form of minutes of directors' meetings (or written consents). Officers taking actions that could have a material effect on the corporation's public benefit purposes or interests *should protect themselves and the corporation* by preparing an internal memorandum or similar written record detailing their consideration of the relevant factors.

  [9:558] ***Reserved.***

2. [9:559] **No Fiduciary Duty to Beneficiaries:** Benefit corporation directors and officers have no fiduciary duty to a beneficiary of the corporation's general or specific public benefit purposes arising from the person's status as a beneficiary. [Corps.C. §§ 14620(i), 14622(d)]

3. [9:560] **Reliance Upon Officers and Experts:** A benefit corporation director may rely, to the same extent as a director of any other for-profit corporation (including an SPC, ¶ *9:83*), on corporate officers and employees; counsel, independent accountants and other professionals; and committees of the board of directors. [Corps.C. § 14620(e); see Corps.C. § 2700(b) (SPCs); *also see* ¶ *6:248 ff.*]

4. [9:561] **No Monetary Liability Under Benefit Corporation Law:** Benefit corporation directors or officers are not liable for monetary damages "*under this part*" (Corps.C. §§ 14600-14631) for any failure of the benefit corporation to create a general or specific public benefit. [Corps.C. §§ 14620(f), 14622(c) (emphasis added); *see* ¶ *9:584*]

Additionally, directors who perform their duties in accordance "with this part" are not liable for monetary damages for any alleged failure to discharge their obligations as a director. Likewise, officers who perform their duties to consider the

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

corporation's public benefit interests and purposes are not liable for monetary damages "under this part." [Corps.C. §§ 14620(g), 14622(c)]

➪ [9:562] ***PRACTICE POINTER:*** A director or officer who considers the corporation's public benefit interests or purposes may nevertheless be liable under *other* Divisions and Parts of the Corporations Code—e.g., under the General Corporation Law where a director acts without disclosing a conflict of interest (Corps.C. § 310, ¶ *6:285 ff.*) or otherwise breaches the director's fiduciary duties.

[9:563 - 9:580] ***Reserved.***

5. [9:581] **Application to Foreign Corporations:** A special rule applies to directors of an out-of-state corporation that has sufficient California contacts to be treated as a "pseudo-foreign corporation" (*see* ¶ *3:5 ff.*): If the director is subject—whether under the corporation's articles, bylaws or laws of its jurisdiction of incorporation—to duties "similar to" the duties of benefit corporation directors under Corps.C. § 14620 (¶ *9:551 ff.*), the director is *not* subject to the director duties set forth in Corps.C. § 309; rather, the director is subject to Corps.C. § 14620. [Corps.C. § 14620(j)]

6. [9:582] **Benefit Enforcement Proceedings:** A violation of a director's or officer's duties regarding the benefit corporation's public benefit interests and purposes may be redressed only through a "benefit enforcement proceeding." Such a proceeding may only be brought (a) *directly by the benefit corporation* or (b) *derivatively* by:

• A *shareholder;*

• A *director;*

• A person or group of persons owning (beneficially or of record) *five percent or more* of the equity interests in an entity of which the benefit corporation is a *subsidiary;* or

• Other persons *specified in the articles or bylaws*. [Corps.C. § 14623(a), (b)]

a. [9:583] **Basis for proceeding:** A "benefit enforcement proceeding" may be brought for:

• Failure to pursue the corporation's general or specific public benefit purpose;

• Violation of a duty or standard of conduct imposed on a director "pursuant to this part" (Corps.C. §§ 14600-14631, ¶ *9:500*); or

• The corporation's failure to deliver or post an annual benefit report (¶ *9:600 ff.*). [Corps.C. §§ 14601(b), 14623(a)]

b. [9:584] **Damages limitation:** A benefit corporation is not liable for monetary damages for any failure to create a general or specific public benefit. [Corps.C. § 14623(c); *see* ¶ *9:561* (director/officer immunity from liability)]

➪ [9:585] ***PRACTICE POINTER:*** Only *injunctive relief* would appear to be available in a benefit enforcement proceeding in view of the damages immunity enjoyed by the corporation and its officers and directors with respect to the corporation's public benefit interests and purposes.

c. [9:586] **Potential attorney fees award to prevailing plaintiff:** The court "may" (discretionary) award attorney fees and expenses to a prevailing plaintiff in a benefit enforcement proceeding where the defendant(s) acted "without justification." [Corps.C. § 14623(d)]

[9:587 - 9:599] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9(II)-D

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part II. Benefit Corporations

D. Annual Benefit Report

1. [9:601] When Due
2. Contents
   a. [9:602] Public purpose narrative
   b. [9:603] Performance assessment
      (1) [9:604] "Third-party standard"
         (a) [9:605] Assessment of impact upon employees, customers, society, etc.
         (b) [9:606] Nature of entity promulgating standards
         (c) [9:607] Public availability of underlying information
   c. [9:622] Relationship with entity establishing third-party standard
   d. [9:623] 5%-or-more owners
   e. [9:624] Failure to pursue public benefit
3. [9:625] Posting/Furnishing of Report

[9:600] The benefit corporation must deliver an annual benefit report to its shareholders. [Corps.C. § 14630]

1. [9:601] **When Due:** The annual benefit report must be delivered within *120 days* following the end of the fiscal year or at the same time that *any other annual report* is delivered to the shareholders. [Corps.C. § 14630(b)]

2. Contents

a. [9:602] **Public purpose narrative:** The annual benefit report must include a narrative description of:

• The process and rationale for selecting the *third-party standard* (*¶ 9:604 ff.*) used to prepare the report;

• The ways in which the *general* public benefit was pursued during the year and the extent to which that benefit was created;

• The ways in which any *specific* public benefit was pursued and the extent to which that benefit was created; and

• Any circumstances that *hindered the creation* of a *general or specific* public benefit. [Corps.C. § 14630(a)(1)]

b. [9:603] **Performance assessment:** The annual benefit report must also include an assessment of the corporation's *overall social and environmental performance*, prepared in accordance with a "third-party standard" (¶ 9:604 ff.) applied consistently with prior benefit reports or accompanied by the reasons for any inconsistencies. The assessment need not be audited or certified by a third party. [Corps.C. § 14630(a)(2)]

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

(1) [9:604] **"Third-party standard"** means a standard for reporting and assessing *overall corporate social and environmental performance*. [Corps.C. § 14601(g)]

The standard must meet all of these criteria:

(a) [9:605] **Assessment of impact upon employees, customers, society, etc.:** The standard must be a *comprehensive assessment* of the *impact* of the business and operations upon:

• The *shareholders;*

• The *employees and workforce* of the benefit corporation, its subsidiaries *and suppliers;*

• The interests of *customers* as beneficiaries of the benefit corporation's general or specific public benefit purposes;

• *Community and societal considerations*, including those of any community in which offices or facilities of the benefit corporation, its subsidiaries or its *suppliers* are located; *and*

• The *local and global environment*. [Corps.C. §§ 14601(g)(1), 14620(b)(1)-(5); *see* ¶ *9:553*]

(b) [9:606] **Nature of entity promulgating standards:** The standard must be developed by an entity that:

• Has *no material financial relationship* with the benefit corporation or any of its subsidiaries;

• Accesses necessary and appropriate *expertise* to assess overall corporate social and environmental performance; and

• Uses a *balanced multistakeholder* approach, including a *public comment* period of at least *30 days* to develop the standard. [Corps.C. § 14601(g)(2) & (3)]

Additionally, the entity must *not* be materially financed by, and *not more than one-third of the members of the entity's governing body* may be representatives of:

• Associations of businesses operating in a specific industry, the performance of whose members is measured by the standard;

• Businesses from a specific industry or an association of businesses in that industry; or

• Businesses whose performance is assessed against the standard. [Corps.C. § 14601(g)(2)(A), (B)]

(c) [9:607] **Public availability of underlying information:** The following information regarding the standard must be publicly available:

• The *criteria* considered when measuring the overall social and environmental performance of a business and their relative weightings;

• The identity of the *directors, officers,* any *material owners*, and the *governing body* of the entity that developed (and controls revisions to) the standard;

• The process by which *revisions* are made to the *standard*, and *changes* are made to the membership of the *governing body* that developed (and controls revisions to) the standard; and

• An accounting of the *sources of financial support for the entity*, with sufficient detail to disclose any relationships that could reasonably be considered to present a potential *conflict of interest*. [Corps.C. § 14601(g)(4)]

[9:608 - 9:620] ***Reserved.***

➪ [9:621] ***PRACTICE POINTER:*** These third-party standards pose the biggest challenge to use of the benefit corporation form. Selecting the right standard can be a daunting task. For background information and a list of organizations that promulgate standards, see *http://benefitcorp.net/how-do-i-pick-third-party-standard*.

 © 2025 Thomson Reuters. No claim to original U.S. Government Works.

In particular, attorneys advising benefit corporations should review the third-party standards selected by the benefit corporation and the entity that promulgated the standards to determine whether the standards and the entity meet the statutory requirements (*¶ 9:606*).

c. [9:622] **Relationship with entity establishing third-party standard:** The report must contain a statement of any *connection* between—on the one hand—the entity that established the third-party standard (*¶ 9:604 ff.*), its directors, officers or “material owners” and—on the other hand—the benefit corporation, its directors, officers and “material owners.” This includes any financial or governance relationship that “might materially affect the credibility” of the objective assessment of the third-party standard. [Corps.C. § 14630(a)(5)]

d. [9:623] **5%-or-more owners:** The annual benefit report must state the name of each person owning five percent or more of the benefit corporation's outstanding shares either beneficially (to the extent known without independent investigation) or of record. [Corps.C. § 14630(a)(3)]

e. [9:624] **Failure to pursue public benefit:** The annual benefit report must contain a statement from the board indicating whether, in the board's opinion, the benefit corporation *failed* to pursue its general and any specific public benefit purpose in all material respects during the year, and if so, a *description* of the ways in which these purposes were not pursued. [Corps.C. § 14630(a)(4); see Corps.C. § 14621]

3. [9:625] **Posting/Furnishing of Report:** All benefit reports must be posted on the benefit corporation's website. If the corporation does not have a website, the *most recent* benefit report must be provided without charge to *any* person requesting the report. (In either event, compensation paid to directors and any financial or proprietary information may be omitted.) [Corps.C. § 14630(c), (d)]

[9:626 - 9:640] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document

© 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9(II)-E

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part II. Benefit Corporations

E. Amendment of Articles to Change Specific Public Benefit

[9:641] A benefit corporation may amend its articles to change any *specific* public benefit purpose stated therein. The amendment must be approved by at least the two-thirds minimum status vote (¶ *9:537*). [Corps.C. § 14610(d)]

[9:642 - 9:650] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9(II)-F

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part II. Benefit Corporations

F. Sale or Other Disposition of Assets

1. [9:651] Two-Thirds Shareholder Approval
2. [9:652] Dissenters' Rights

1. [9:651] **Two-Thirds Shareholder Approval:** A sale, lease or other disposition of all or substantially all of the benefit corporation's assets (other than a transaction in the usual and ordinary course of business) must be approved by at least the two-thirds minimum status vote (*¶ 9:537*). [Corps.C. § 14604(d)]

2. [9:652] **Dissenters' Rights:** Holders of "dissenting shares" (see Corps.C. § 1300(b)) have the full dissenters' rights set forth in the General Corporation Law (Corps.C. § 1300 et seq.; *see ¶ 8:292 ff.*). [Corps.C. § 14604(d)]

[9:653 - 9:660] ***Reserved.***

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.

Cal. Prac. Guide Corps. Ch. 9(II)-G

The Rutter Group | July 2024 Update

California Practice Guide--Corporations
Original Author: C. Hugh Friedman; Current Edition Authors: Jeffrey C. Soza, Matthew Jann; Consulting Editor: Evridiki 'Vicki' Dallas; Prior Edition Authors: James F. Fotenos, Edward C. Rybka

Chapter 9 Part II. Benefit Corporations

G. Termination of Benefit Corporation Status

1. [9:662] Articles Amendment
  a. [9:663] Two-thirds shareholder approval
  b. [9:664] Dissenters' rights
2. [9:665] Reorganization—Two-Thirds Shareholder Approval Required
3. [9:666] Conversion—Two-Thirds Shareholder Approval Required

[9:661] A benefit corporation may terminate its benefit corporation status by amendment of its articles or by reorganization or conversion. [Corps.C. § 14604]

1. [9:662] **Articles Amendment:** A benefit corporation may amend its articles to delete both the statement that it is a benefit corporation and any stated specific public benefit. [Corps.C. §§ 14604(a), 14610(d)]

a. [9:663] **Two-thirds shareholder approval:** The amendment must be approved by at least the two-thirds minimum status vote (*¶ 9:537*). [Corps.C. § 14604(a)]

b. [9:664] **Dissenters' rights:** Holders of "dissenting shares" (see Corps.C. § 1300(b)) have the full dissenters' rights set forth in the General Corporation Law (Corps.C. § 1300 et seq.; *see ¶ 8:292 ff.*). [Corps.C. § 14604(a)]

2. [9:665] **Reorganization—Two-Thirds Shareholder Approval Required:** A reorganization (*see ¶ 8:235 ff., 8:259 ff.*) that has the effect of terminating the corporation's status as a benefit corporation must be approved by at least the two-thirds minimum status vote (*¶ 9:537*). [Corps.C. § 14604(b)]

3. [9:666] **Conversion—Two-Thirds Shareholder Approval Required:** If a benefit corporation converts to another entity (*see ¶ 8:451 ff.*), the conversion must be approved by at least the two-thirds minimum status vote (*¶ 9:537*). [Corps.C. § 14604(c)]

© 2024 by The Rutter Group, a Thomson Reuters Business. No Claim to Orig. U.S. Govt. Works.

End of Document © 2025 Thomson Reuters. No claim to original U.S. Government Works.