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Proposed Legislation

A PROPOSAL FOR REVISION OF SECTIONS ON SHAREHOLDERS' LIABILITY FOR UNAUTHORIZED DIVIDENDS AND DISTRIBUTIONS IN LIQUIDATION

A recent district court of appeal decision made the astonishing ruling that where a shareholder knowingly participates in an informal distribution of assets by an insolvent corporation, there is no remedy against the shareholder for the benefit of the injured creditors, the corporation not having been adjudged insolvent or bankrupt in any action or proceeding begun within one year after the receipt of such distribution.¹

The court's interpretation of the section of the General Corporation Law pertaining to liability for unauthorized dividends² which was made the basis of the decision, has been previously criticized.³ It was suggested that an amendment to the statute should be proposed to obviate further denial of remedy.⁴ The writer here sets forth specifically the arguments for this proposal.

¹ *Oilwell Chemical & Materials Co. v. Petroleum Supply Co.* (1944) 64 A. C. A. 439, 148 P. (2d) 720.

² CAL. CIV. CODE §364.

³ (Sept. 1944) 32 CAL. L. REV. 312.

⁴ *Ibid.*, at 315.

As the section now reads, recovery of dividends wrongfully distributed to a *mala fide* recipient is allowed only in the relatively rare instances in which the corporation has been adjudged insolvent or bankrupt in an action or proceeding begun within one year after the receipt of such dividend. This restriction was imposed in 1933.⁵ In that year a similar provision was inserted in the section dealing with the right of recovery from shareholders of wrongful withdrawals by sales to the corporation of its own shares.⁶ The practical effect of these amendments, especially in view of the *Oilwell* decision,⁷ has been to eliminate two important safeguards of the rights of creditors.⁸ In not a single case reaching the appellate courts during the eleven year life of these amendments has there been prosecuted a claim against shareholders under either of the amended sections. The only California appellate cases since 1933 in which statutory remedies were invoked against shareholders in either wrongful dividend or wrongful share repurchase cases involved actions falling under the predecessors of the restrictive 1933 statutes.⁹ The plaintiff corporation in the *Oilwell* case was not attempting to recover under the wrongful dividend statute; rather was it hoping to avoid the possible trap presented by that section; but the trap was closed by the court's limiting the plaintiff's remedy to the provisions of that section.¹⁰ The need of adequate remedy is indicated not only by California case history, but also by the frequency with which similar cases have arisen in other jurisdictions.¹¹

⁵ Cal. Stats. 1933, p. 1397.

⁶ Cal. Stats. 1933, p. 1398.

⁷ *Supra* note 1.

⁸ For the rights of creditors against shareholders for wrongful dividends see 12 FLETCHER, *CYC. CORP.* §5423, p. 192; Fuld, *Recovery of Illegal and Partial Liquidating Dividends from Stockholders* (1941) 28 VA. L. REV. 50; comment (1933) 33 COL. L. REV. 481; (1932) 30 MICH. L. REV. 1070; (1939) 38 *ibid.* 689. See also, comprehensive annotations in (1928) 55 A.L.R. 98, (1932) 76 A.L.R. 892, and (1937) 109 A.L.R. 1398.

For the rights of creditors against shareholders for wrongful repurchases of shares by the corporation see 15A FLETCHER, *op. cit. supra* §7419, p. 156; Dodd, *Purchase and Redemption by a Corporation of its Own Shares: the Substantive Law* (1941) 89 U. OF PA. L. REV. 697, 710, 711; Warren, *Safeguarding Creditors of Corporations* (1923) 36 HARV. L. REV. 509, 539, 544; Blackstock, *A Corporation's Power to Purchase Its Own Stock and Some Related Problems* (1935) 13 TEX. L. REV. 442, 446 ("What Constitutes Protection to Creditors?"); comment (1938) 47 YALE L. J. 1164, 1170.

⁹ *American Trust Co. v. California Western States Life Ins. Co.* (1940) 15 Cal. (2d) 42, 54 f., 98 P. (2d) 497 (Action for declaratory relief involving sec. 365 as it read prior to 1933 amendments); *Hansen v. California Bank* (1936) 17 Cal. App. (2d) 80, 61 P. (2d) 794 (Liability of shareholder for wrongful stock purchase under former sections 309, 354, Civil Code).

¹⁰ See *supra* note 3, at 313 f.

¹¹ *Supra* note 8.

An analysis of the provisions of the sections reveals their stringent restrictiveness. For example, in the wrongful dividend section,¹² the requirement of proof of "knowledge of facts indicating the impropriety" of the dividend on the part of the shareholder, although a desirable provision,¹³ in itself eliminates from recovery a great proportion of instances of wrongful distributions of dividends to shareholders. Obviously the practical effect of this restriction alone is to limit recovery to cases involving closely held corporations or against director shareholders or informed employee shareholders of the larger corporations. When on top of this, the further requirement of an adjudication of insolvency or bankruptcy in an action or proceeding begun within one year after the receipt of the dividend¹⁴ is imposed, the chance of any particular case falling within the scope of the section becomes almost negligible.

Moreover, in its limitation of remedy afforded to creditors against *mala fide* recipients of wrongful dividends or wrongful share repurchases California stands alone. Legal writers, in discussing the relatively liberal remedies afforded by other jurisdictions, find it necessary to list California as a somewhat curious exception.¹⁵

To bring these sections into conformity with other provisions of the General Corporation Law, and to provide adequately for every

¹² *Supra* note 2.

¹³ The prevailing view in the absence of statute is that where a corporation is insolvent at the time of or is made insolvent by the dividend payment, the shareholder must disgorge irrespective of his innocence. *Powers v. Heggie* (1929) 268 Mass. 233, 242, 167 N. E. 314, 317; *Wood v. Nat. City Bank* (C.C.A. 2d, 1928) 24 F. (2d) 661, 663; 12. FLETCHER, *op. cit. supra* note 8, §5423, p. 130.

Where the corporation is solvent at the time of the distribution, and the shareholder acts in good faith, it has been held that no recovery may be had. *McDonald v. Williams* (1898) 174 U. S. 397.

Section 364, Cal. Civ. Code, is in accord with this federal view. The drafters of the section felt that an innocent shareholder, one who has no reason to suppose that the dividend was improper, should not be held bound to return it to the corporation, irrespective of the state of solvency of the corporation.

For citations to leading articles and cases covering this general topic, see *supra* note 3, at 313, n. 6, 7, 8 and 9.

¹⁴ Section 365 authorizes recovery only from sellers of shares "knowing that the corporation is the purchaser with knowledge of facts indicating the impropriety of such purchase". Thus it must be proved that the shareholder knew (1) that the corporation was the purchaser and (2) facts indicating the impropriety of the purchase. For an excellent discussion of these requirements, see *Dodd, op. cit. supra* note 8, at 710, 711.

The restrictive provision in section 365 corresponding to that found in section 364 allows recovery only "in the event that the corporation is adjudged insolvent or bankrupt in any action or proceeding begun within one year after such purchase."

It may therefore be concluded that the probability of any wrongful share repurchase case falling within the scope of section 365 is no greater than that of a wrongful dividend action falling within the provisions of section 364.

¹⁵ *Dodd, op. cit. supra* note 8, at 710, n. 54. *Fuld, ibid.*, at 65, n. 90.

situation, further changes are needed. At present there is no section specifically worded to cover the aggravated case where the corporation is informally stripped of its assets followed by delivery thereof to the shareholders in utter disregard of the rights of creditors. In the Civil Code, section 402 provides for the liability of shareholders for distributions of assets in "the process of winding up" without payment of or provision for debts and liabilities. It is doubtful, however, whether or not the present wording of this section covers liquidating distributions not made in the course of dissolution proceedings under Chapter XV.¹⁶ Recent decisions¹⁷ indicate the desirability of express coverage of such informal distributions. The policy calling for sanctions in event of informal liquidation is certainly as great as that behind sanctions now clearly imposed by section 402 upon liquidation under Chapter XV. The formality of the winding up procedure followed is certainly immaterial in so far as the rights of the creditors are concerned. Section 402 should accordingly be reworded so as to cover clearly all situations of liquidation in contemplation of going out of business. The need for change in the protection of creditor interests is particularly aggravated at present by the existence in this state of numerous mushroom war corporations, a large proportion of which will liquidate and go out of business upon the termination of hostilities.

Dividends paid out of capital or during insolvency are included within the scope of the restraining sanctions imposed by section 364.¹⁸ The section has, by an over-expansion of the scope of the term "dividend", been misinterpreted to cover cases of corporate liquidation by informal stripping.¹⁹ The blunt terms of section 402, omitting as they do any requirement of knowledge on the part of the share-

¹⁶ The phrase "process of winding up" is used continually throughout Chapter XV (CAL. CIV. CODE §§399-404c) to describe the formal procedure for terminating the corporate life outlined therein. A very plausible construction of the scope of the phrase as used in section 402 would therefore be that it is limited to proceedings under the formal provisions of these sections. The fact that neither the attorney's plaintiff nor the court in the Oilwell case (*supra* note 1) apparently thought of the possible invocation of section 402 (see *supra* note 3, at 314) further indicates the probable limited scope of the current wording of the section.

¹⁷ Oilwell Chemical & Materials Co. v. Petroleum Supply Co., *supra* note 1; *cf.* similar corporate stripping in Saracco Tank & Welding Co. v. Platz (1944) 65 A. C. A. 485, 150 P. (2d) 918 (directors of Nevada corporation, with knowledge and in disregard of existence of creditor's claim, transferred all assets to new California corporation).

An example of corporate stripping similar to that involved in the Saracco case is found in Darcy v. Brooklyn & N. Y. Ferry Co. (1909) 196 N. Y. 99, 89 N. E. 461, 26 L. R. A. (N. S.) 267.

¹⁸ CAL. CIV. CODE §346.

¹⁹ Oilwell Chemical & Materials Co. v. Petroleum Supply Co., *supra* note 1; see *supra* note 3, at 313 f.

holders, are, however, intended to cover this more serious infringement of creditor rights. The provisions in this section for inter-shareholder contribution for the equalization of the liability burden and the preservation of preference rights are also adapted to specific coverage of informal abandonment of the corporate business. To remove the danger of overlapping, section 364 might be amended so as to exclude from its scope distributions covered by section 402.

It is therefore proposed that section 364 of the California Civil Code be amended as follows:

"364. Improper dividends.

Any shareholder or owner of shares who receives any dividend, *except a distribution covered by section 402, Civil Code*, not authorized by this title with knowledge of facts indicating the impropriety thereof shall be liable to the corporation or to its receiver, liquidator or trustee in bankruptcy for the amount so received by him with interest thereon at seven per cent per annum until paid in the event ~~that the corporation is adjudged insolvent or bankrupt in any action or proceeding begun within one year after the receipt of such dividend.~~ Any number of shareholders may be sued in the same action."

It is proposed that section 402 be amended by inserting therein the following sentence as the last paragraph thereof:

"The phrase 'process of winding up' as used in this section shall include proceedings in conformity with the provisions of this Chapter and any distribution of assets to shareholders made in contemplation of termination or abandonment of the corporate business."

It is to be noted that section 364 provides for the recovery of seven per cent interest on the amount received by the shareholder until the liability imposed by the section be paid. Section 365 imposes no interest damages. There seems no reason for the discrepancy, the injury to creditors²⁰ and the wrongfulness of the shareholder's action being the same in both cases. Section 365 should be brought into conformity with section 364 in this respect.

It is therefore proposed that section 365 be amended as follows:

"365. Unauthorized sale of shares.

When a corporation, in violation of any provision of this title, purchases shares issued by it, any shareholder or owner of shares

²⁰ Warren, in *Safeguarding the Creditors of Corporations* (1923) 36 HARV. L. REV. 509, 542, writes: "If a corporation purchases and pays for shares of its own stock the immediate effect upon the position of its creditors is precisely the same as if it had distributed a dividend to its stockholders equal to the amount of the purchase price." See also, Dodd, *op. cit. supra* note 8, at 710, 711.

who sells such shares knowing that the corporation is the purchaser with knowledge of facts indicating the impropriety of such purchase shall be liable to the corporation or its receiver, liquidator or trustee in bankruptcy to the extent of the payments received therefor *with interest thereon at seven per cent per annum until paid* and for the unpaid balance of the subscription price due thereon, if any, ~~in the event that the corporation is adjudged insolvent or bankrupt in any action or proceeding begun within one year after such purchase.~~²¹

The argument for the applicability of the Uniform Fraudulent Conveyance Act²¹ to wrongful distributions of assets to shareholders has been previously discussed.²² Under the proposed amendments, the desirable result of allowing recovery from *mala fide* shareholder recipients of dividends paid, or payments for share repurchases made during insolvency would be effectively obtained without the necessity of resort to the U.F.C.A.²³

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²¹ CAL. CIV. CODE, §§3439 to 3439.12.

²² See *supra* note 3, at 315.

²³ Section 364 allows recovery only for receipt of dividends not authorized by the General Corporation Law. A similar provision is found in section 365 as to recovery of payments made for corporate share repurchases. Section 346 provides: "No dividends shall be declared when there is reasonable ground for believing that thereupon the corporation's debts and liabilities would exceed its assets, or that it would be unable to meet its debts and liabilities as they mature." The corresponding insolvency restriction on share repurchases is found in CAL. CIV. CODE §342.

Note, however, direct remedies available to creditors against fraudulent recipients under the U.F.C.A. (CAL. CIV. CODE §3439.09). It could be argued with strength at least in cases involving actual fraudulent intent, that this section affords additional remedy in wrongful dividends and share repurchase cases.