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## Law Alert

**To:** Firm Clients and Contacts

**From:** Niesar & Vestal LLP

**Date:** March 20, 2012

**Re:** **Succession Planners Beware! Section 500 Amendments Impact Use of Promissory Note in Stock Buyback**

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As a result of recent amendments to Section 500 of the California Corporations Code which took effect January 1, 2012, if a corporation issues a promissory note to pay the purchase price for the repurchase or redemption of outstanding shares, the note is permanently subordinated to any and all creditor claims, whether in existence at the time the note was issued, or arising years later. This is because now each payment of principal or interest on the indebtedness will be treated as a corporate distribution at the time the payment is made. Thus, on each date a payment of principal or interest is to be made, the corporation must first satisfy the Section 500 retained earning or balance sheet tests applicable to corporate distributions, which subjects the departing shareholder to the risk of not receiving principal and/or interest payments if the corporation has insufficient retained earnings or assets at the time the payments are to be made.

Prior law provided that if the Section 500 tests were met at the time the redemption note was issued, the redemption note would rank as a creditor claim, according to its terms.

This change in law could have a serious impact on the structuring of succession planning for owners of California corporations. A common strategy in succession planning for a corporation's principal owners involves a purchaser of the business who does not pay the entire price of the business upfront, in order to offer a more favorable price to the seller. In such case, the purchaser will often purchase a small amount of stock, with the remainder of the stock repurchased from the seller by the corporation, with consideration consisting of a redemption

note issued by the corporation to the seller. This structure worked well under prior law where the seller had built up the business over many years, resulting in significant retained earnings in the corporation at the time of the sale of the business. This meant that when the redemption note was issued to the seller, the corporation could satisfy the Section 500 tests. Now, under the new law, the seller is exposed to the risk that, although the Section 500 tests are satisfied at the time of sale, due to the purchaser subsequently incurring additional debt or decreasing retained earnings through losses, future payments of principal or interest do not satisfy the Section 500 tests and seller does not get paid. This would be the result even if the redemption note is secured. The seller is therefore taking on the added risk of not getting paid should the purchaser's running of the business not be as profitable as expected at the time of sale.

The procedures and strategies used in succession planning for corporate owners will need to be reexamined in light of this dramatic change in Section 500. The same issue may arise in agreements such as standard Founder's Stock Agreements allowing the corporation to repurchase founder or employee stock and issue a promissory note as consideration for the repurchase.

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