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State Statutory Restrictions on Financial Distributions by Corporations to Shareholders, Part II

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STATE STATUTORY RESTRICTIONS ON
FINANCIAL DISTRIBUTIONS BY
CORPORATIONS TO SHAREHOLDERS

Part II

Richard O. Kummert*

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I. INTRODUCTION

It appears that we have entered an era of reform for state statutes that regulate payments by corporations to their shareholders. With the benefit of hindsight, it is now apparent that the era began with the adoption by the California legislature in 1975 of that state's unique series of restrictions on dividends and share repurchases by corporations. That development was followed in 1977 with the publication by Bayless Manning of an eloquent plea for the elimination of most state restrictions on corporate financial distributions to shareholders. The reform movement then received a substantial boost in 1979 when the Committee on Corporate Laws of the American Bar Association Section on Corporation, Banking, and Business Law completely revised the financial provisions in the Model Business Corporation Act. As a result of the interest generated by these developments, at least six states have recently adopted significant changes in their corporate financial provisions, and a number of other states have considered, or are considering, changes of similar dimension. It seems

probable that over the next ten years most state legislatures will be asked to reevaluate the statutory systems by which they regulate corporate financial distributions to shareholders.

Rational legislative inquiry on such a subject would seem to require at a minimum identification of alternatives available, assessment of the costs and benefits related to each alternative, and finally selection of an alternative providing an acceptable balance of costs and benefits and reasonable consistency with general social goals. Existing literature has not been particularly helpful in supplying assistance on any part of this inquiry. One of the major effects of the reform movement has been an expansion in the number of alternatives available to legislatures concerning statutory regulation of corporate financial distributions. Yet there has been no recent comprehensive analysis of statutes in the United States dealing with the subject. More importantly, determination of the respective costs and benefits of each of the major statutory systems has not to my knowledge been undertaken. This article therefore attempts to provide information related to, and an analytical approach for, the first two areas of legislative concern. Its conclusion should also provide some insight regarding the ultimate selection of statutory provisions regulating corporate financial distributions.


8. The effects of statutory restrictions on corporate financial distributions upon income distribution is an extremely difficult and subjective inquiry. To the extent such restrictions operate to increase losses falling upon small creditors of corporations without significant amounts of long-term debt, it is arguable that such restrictions may particularly impact employees of such enterprises. It is also arguable that most employees of such corporations come from lower-income levels. But other trade creditors may also be impacted by such losses, and such creditors appear likely to be randomly distributed over the income distribution scale. Further, it is not clear that shareholders receiving distributions in some way implicated in the losses ultimately suffered are not also randomly distributed over the income scale. Since there is no reasonable way of determining any conclusive pattern to possible losses from any set of statutory restrictions, the issue of the effects of the restrictions upon income distribution is left to general legislative analysis.

9. The most recent law review article appears to be Kreidmann, Dividends—Changing Patterns, 57 COLUM. L. REV. 372 (1957). B. MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL 59-77, 164-180 (2d ed. 1981) provides a general description of most of the statutes currently in operation in the United States. But he offers no indication as to relative use of such statutes by the various states. That information can be obtained with some effort from the MODEL BUSINESS CORP. ACT ANN. (2d ed. 1969 & Supps. 1973, 1977). Unfortunately, the annotations have not been updated since 1977.

The laws of other countries provide few concepts that are not present in some form in current American statutes. See P. Nordquist, Regulation of Financial Distributions in Foreign Countries (April 1, 1983) (unpublished manuscript) (copy on file with the Washington Law Review). The most prominent exception, the English Companies Act, 1980, ch.22, is discussed infra note 460.
Restrictions on Corporate Distributions

The main body of my analysis of state statutory restrictions on corporate financial distributions appears in the second section following this introduction. The intervening section provides a brief summary of the interests of groups in society that are affected by such restrictions. That material, derived from the first part of this article, forms the necessary underpinning for the analysis of costs and benefits resulting from any form of regulation of corporate financial distributions.

II. SOCIETAL INTERESTS IN CORPORATE FINANCIAL PROVISIONS

The groups affected by state statutory restrictions on corporate financial distributions can be broadly divided into persons concerned with the amount of corporate financial distributions (common shareholders, senior security holders, general creditors, corporate officers, employees, and the public) and persons involved in the administration of the statutory restrictions (directors, lawyers, accountants, and judges).

A. Persons Interested in the Amount of Corporate Financial Distributions

1. Distributions by Way of Dividend

a. Common Shareholders

Shareholder interests appear to vary dramatically with the size and ownership of the corporation involved. Shareholders actively involved in a small, closely held corporation are likely for tax reasons to prefer that any distributions be by means other than dividend payments. Shareholders in a publicly held corporation, on the other hand, appear to value stability in dividend payments by the corporation and to view changes in the amount of such payments as signalling alterations in management's perception of the corporation's future profitability.

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11. Id. at 372-73. Thus, the two means by which funds are typically distributed by closely held corporations to shareholders are by salary payments and by share repurchases.
12. See id. at 370-71.
b. Senior Security Holders

Holders of preferred shares and intermediate or long-term debt issued by a corporation usually have a strong interest in the corporation’s long-term solvency. Such interest is usually manifested in contractual restrictions upon the corporation’s ability to pay dividends to, or make repurchases of shares from, its shareholders, which are more stringent than the statutory restrictions on such distributions imposed by the corporation’s state of incorporation.

c. General Creditors

The primary concern of general, unsecured creditors—typically short-term creditors—is that the corporation retain sufficient funds to pay its current obligations as they become due in the ordinary course of business. Such creditors also have an interest in the corporation’s continued existence as a viable, growing source of business. General creditors receive relatively free assistance toward both goals if they are fortunate enough to deal with a corporation subject to contractual restrictions imposed by senior security holders.

d. Corporate Officers

Despite corporate legal norms, it appears that officers determine the financial policy of most corporations. Top management’s primary interest in connection with dividend payments appears to be retaining maximum flexibility with respect to the direction of the corporation’s assets.

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14. Kummert, supra note 10, at 373–74. Senior security holders are interested in the ability of the corporation to produce sufficient cash to pay annual returns on the securities throughout their life, and to maintain net assets that even in the event of financial adversity will be at least equal in value to the securities’ liquidation preference. For a recent attempt to protect such interests against the effects of a distribution, see Robinson v. T.I.M.E.-DC, Inc., 566 F. Supp. 1077 (N.D. Tex. 1983) (a spin-off of major assets held not to constitute a “liquidation” for purposes of preferred shares’ liquidation rights).


16. General creditors benefit in such circumstances to the extent that the operation of the covenant causes the corporation to retain more assets than it would have otherwise retained. Such creditors will also benefit from the monitoring undertaken by the senior security holder to ensure the corporation’s compliance with the covenant. Cf. Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 YALE L.J. 49, 49–59 (1982) (discussing the freeriding problem in relationship to the monitoring typically done by a secured creditor).

17. Corporate law formally vests the power to determine distribution policy for a corporation in its board of directors. See, e.g., MODEL BUSINESS CORP. ACT §§ 6, 35, 45 (1979).

Restrictions on Corporate Distributions

e. Employees

Employees on occasion may be a corporation's primary short-term creditor, and on such occasions desire that the corporation retain sufficient funds to pay current obligations as they become due. More generally, employees have a strong interest in the continued profitable operation of the corporate employer. 19

f. The Public Interest

The public presumably has a strong interest in the continued profitable operation of most corporations. 20 Various governmental units tax dividends received as income; such units therefore have a direct interest in the aggregate amount of dividends paid, and on occasion, when such dividends are paid. 21

2. Distributions by Way of Share Repurchase

a. Common Shareholders

Shareholder interests vary with the type of corporation involved, and with the impact of the repurchase upon the shareholder's ownership interest. Shareholders of closely held corporations attach great importance to share repurchases. Such transactions are frequently the only means by which the selling shareholder can realize upon his or her investment and by which the remaining shareholders can retain control over participants in the enterprise. 22 Shareholders of both closely held and publicly held corporations generally prefer for tax reasons that excess funds be distributed to shareholders by share repurchase rather than by dividend. 23 Shareholders not tendering shares in a repurchase by a publicly held corporation may benefit economically in certain circumstances. 24

19. Id. at 380–81.
20. Indeed, if profits are determined after a reasonably thorough determination of costs caused by the corporation, the public interest would appear to be in continued operation of all profitable corporations.
22. Id. at 391–92. Both sets of shareholders may gain if a repurchase ends disharmony among shareholders threatening the corporation's existence.
23. See id. at 361 n.8. This statement assumes that the repurchase is treated as being in exchange for the shares under I.R.C. § 302(b) (1976 & Supp. V 1981), and thus that the seller is entitled to long-term capital gain treatment on any gain realized. Because of § 243 of the Internal Revenue Code, corporate shareholders may prefer dividends to share repurchases. I.R.C. § 243 (1976 & Supp. V 1981). Tax exempt organizations are presumably indifferent between the two forms.
24. Remaining shareholders may benefit if the corporation repurchases shares at a bargain price, or if the corporation's earnings per share will increase more as a result of the repurchase than they
b. All Other Groups

Generally, a change in the form of a proposed distribution from a dividend to a share repurchase will not affect the interests of the remaining groups discussed above. However, senior security holders, short-term creditors, and employees will prefer such a change if it ends shareholder disharmony and avoids liquidation of a closely held corporation. The same groups will prefer such a change by a publicly held corporation if the repurchase eliminates small shareholders and concomitant disproportionate service costs. Finally, governmental units imposing taxes based on income will face a reduction of tax revenue if there is a substantial shift from making distributions in the form of dividends to repurchases of shares.

B. Persons Involved in the Administration of the Statutory Restrictions

It appears that all persons engaged in the administration of the statutory restrictions on corporate financial distributions have some interest in the rules being intelligible, unambiguous, and permissive.

Directors are interested in the content of the rules because most statutes regulating financial distributions make assenting directors personally liable for illegal distributions. Directors seeking to avoid such liability, and to minimize the corporation’s expense, will prefer rules that are intelligible and unambiguous regarding restricted transactions and available defenses. They will also prefer, following top management’s preference for flexibility noted above, rules that are permissive.

Persons who advise directors on such matters—lawyers, accountants, and appraisers—appear likely to have mixed emotions about rules that are intelligible, unambiguous, and permissive. Advisers who give such advice infrequently will prefer such rules as enabling them, rather than corporate specialists, to provide service without fear of malpractice. Corpo-
rate specialists, and perhaps the bar at large, may conclude that rules meeting the three criteria will reduce significantly the aggregate amount of expert time spent on opinions related to the legality of distributions.32

The interest of judges with respect to the content of restrictions on corporate financial distributions relates primarily to the probable effects of such rules on the volume and complexity of litigation arising because of the rules. There is no reason to believe that adoption of intelligible, unambiguous, and permissive rules would have any effect other than reducing the already small number of distribution cases litigated.33 Further, such rules should reduce the complexity of any cases that do proceed to trial.

III. ANALYSIS OF CURRENT STATE STATUTORY RESTRICTIONS ON CORPORATE FINANCIAL DISTRIBUTIONS

State legislatures desiring to reevaluate their corporate financial provisions must first identify for consideration a reasonable range of alternative means of dealing with the area. The statutes currently in effect in the United States provide a suitable array of possible alternatives. Current statutes range broadly from those that are complex to those that are relatively simple, from those that are based on familiar concepts to those that are based on innovative constructs, and most importantly, from those that are deregulatory in purpose to those that are protective in outlook. This section, therefore, seeks first to categorize and describe major current statutes as an aid to legislative consideration. It then attempts to assess the relative costs and benefits of each of the major statutory systems.

State restrictions on corporate financial distributions are currently imposed by two different bodies of law: restrictions that appear in the state’s general corporation act, and restrictions that result from the operation of the state’s fraudulent conveyance rules.34 One of the major questions that a legislature reexamining its statutory scheme must address is whether provisions in its general corporation act should be made the exclusive determinant of rights related to corporate financial distributions.35 To

32. See Kummert, supra note 10, at 393–94.
33. On the volume of such litigation, see id. at 394 & nn.156–57.
34. State fraudulent conveyance rules may have their source in statutes or in state common law. See infra notes 377–78. In addition, the federal bankruptcy statute imposes a set of rules highly similar to, but not identical to, the most common series of state statutes.
35. The catalyst for discussion of this issue was the decision by the Committee on Corporate Laws of the Section on Corporate, Banking, and Business Law of the American Bar Association to provide an optional provision in the Amended Model Act that would preempt the operation of the
highlight that possibility, this section at the outset considers and compares provisions that appear in states' general corporation acts. It then examines restrictions imposed by operation of states' fraudulent conveyance laws and analyzes the preemption issue.

A. Corporate Law Restrictions on Financial Distributions

In the great majority of state corporation acts, restrictions on corporate distributions to shareholders are based, at least nominally, on the concept of "legal capital," i.e., the notion that a corporation, in order to protect its creditors and its common and preferred shareholders, should retain a margin of net assets at least equal to its stated capital. This section will first examine the provisions in the Model Business Corporation Uniform Fraudulent Conveyance Act provisions with respect to corporate financial distributions. See Amendments (1979), supra note 4, at 1877, 1882–83.

36. Only five states—California, Massachusetts, Minnesota, Montana, and New Mexico—currently have statutes that do not utilize the concept of legal capital. See infra notes 205, 274 & 330.

37. Sixteen of the 45 states that use legal capital as a base for their statutory systems (these 45 states are listed infra notes 41 & 133) also permit "nimble dividends" from current earnings in the absence of any kind of surplus. See ARIZ. REV. STAT. ANN. § 10-045(A)(1) (1977); ARK. STAT. ANN. §§ 64-402(A)(3) (1980); DEL. CODE ANN. tit. 8, § 170(a)(2) (1983); GA. CODE ANN. § 14-2-90(A)(1) (1977); KAN. STAT. ANN. §§ 17-6420(a)(2) (1981); KY. REV. STAT. § 271A.225(1)(a) (1983); LA. REV. STAT. ANN. § 12:63B (West 1963); ME. REV. STAT. ANN. tit. 13-A, § 514(1)(A) (1964); NEV. REV. STAT. § 78-290(1) (1979); N.H. REV. STAT. ANN. §§ 293-A:45(1)(a) (Supp. 1983); N.C. GEN. STAT. §§ 12-55, 12-56 (1967); OKLA. STAT. ANN. tit. 18, § 1.132(a)(3) (1955 & Supp. 1982–83); R.I. GEN. LAWS §§ 7-1-1-A, 7-1-40-a(69) (1969); TENN. CODE ANN. § 48-511(1)(a) (1979); VT. STAT. ANN. tit. 11, § 1889(a)(1) (1973); WASH. REV. CODE § 23A.08.420(1)(b) (1983). For corporations in these states, one can argue that the operative limitation on dividends will be the nimble dividend provisions. Similarly, of the states with systems based nominally on "legal capital," all but four, see ILL. ANN. STAT. ch. 32, §§ 157.6, 157.67, 157.8 (Smith-Hurd 1954 & Supp. 1983–84); Mich. Comp. Laws §§ 400.1351, 400.1355 (1994); Mo. Stat. Ann. §§ 351.210, 351.220, 351.230 (West 1957 & Supp. 1982–83), empower natural resource corporations to ignore depletion deductions in determining permissible distributions. See infra notes 41 & 133 (listing states). However, none of the states with either nimble dividend or depletion-reserve dividend provisions permit repurchase of shares out of either source; all instead regulate such distributions with provisions based on legal capital. It is clear that for many corporations the restrictions on repurchases are far more important than the restrictions on dividends. See Kummert, supra note 10, at 396–97 n.168. Thus, it seems fair to characterize states with either nimble dividend or depletion-reserve dividend provisions as having provisions based on legal capital.

Some may disagree with the determination that the provisions in the Model Business Corporation Act are based on the concept of legal capital. Such an argument would be premised on the Act's use of earned surplus as a primary source for dividends and as a measure for share repurchases, and the use of a definition for that term that does not involve stated capital. See MODEL BUSINESS CORP. ACT §§ 2(1), 6, 45 (1979). However, capital surplus can also be used for such purposes in specified circumstances. See id. §§ 6, 46. Capital surplus is defined under the Act by reference to stated capital. Id. § 2(k), (m). Thus, legal capital is again the central concept.

38. See H. BALLANTINE, CORPORATIONS 570–72 (rev. ed. 1946); D. KEHL., CORPORATE DIVIDENDS 1–20 (1941). The concept and its history are also discussed extensively in B. MANNING, supra note 9, at 1–108.
tion Act prior to its 1980 revision, which is the most popular statutory series currently utilizing the concept. It will then examine the provisions used by jurisdictions that employ the balance sheet surplus test on financial distributions, which is an almost equally popular statutory sequence based on the legal capital concept. Finally, this section will examine the provisions in effect in the relatively few states that do not base their statutory systems on the concept of legal capital.

I. Statutory Systems Based on Legal Capital

a. Pre-1980 Model Business Corporation Act

Twenty-nine states have adopted the substance of the financial provisions in the pre-1980 Model Business Corporation Act.41

i. Summary of the Model Act Provisions

Under the Model Act, corporations may pay dividends to shareholders


40. Sixteen states and the District of Columbia use the balance sheet surplus approach. See infra notes 133–34. But included in the list are such large commercial states as Delaware, Florida, Illinois, Michigan, New Jersey, New York, and Ohio. Thus, there is a substantial likelihood that the balance sheet surplus test affects more corporations than the provisions based on the Model Business Corporation Act. For a list of states whose statutes are based on the Model Act, see infra note 41.

in cash or property only out of their unreserved and unrestricted earned surplus.\textsuperscript{42} Such dividends may not be paid when a corporation is insolvent or when payment would render the corporation insolvent, or when payment would be contrary to any restriction contained in the corporation’s articles of incorporation.\textsuperscript{43} If the corporation’s articles of incorporation so provide, or if the holders of a majority of the outstanding shares of each class so vote,\textsuperscript{44} a corporation upon proper disclosure may distribute to its shareholders cash or property out of capital surplus.\textsuperscript{45} No distribution from capital surplus shall be made when the corporation is insolvent or when the distribution would render the corporation insolvent.\textsuperscript{46}

Purchases of a corporation’s own shares may be made only to the extent of the corporation’s unreserved and unrestricted earned surplus,\textsuperscript{47} and if its articles of incorporation so permit, or if the holders of a majority of all shares entitled to vote thereon so vote, to the extent of the corporation’s available unreserved and unrestricted capital surplus.\textsuperscript{48} No purchase of or payment for the corporation’s own shares shall be made when it is insolvent or when such purchase or payment would make it insolvent.\textsuperscript{49} To the extent that earned or capital surplus is used as the measure of the corporation’s right to purchase its own shares, such surplus is restricted as long as such shares are held as treasury shares. Upon disposition or cancellation of any such shares, the restriction is removed pro tanto.\textsuperscript{50}

The Model Act excepts from the surplus limitation purchases or other

\textsuperscript{42} \textsc{Model Business Corp. Act} § 45(a) (1979).
\textsuperscript{43} \textit{Id.} § 45.
\textsuperscript{44} The holders of each class vote for this purpose whether or not entitled to do so by the corporation’s articles of incorporation. \textit{Id.} § 46(b).
\textsuperscript{45} \textit{Id.} § 46(e). No such distribution shall be made to the holders of any class of shares unless all cumulative dividends accrued on all preferred or special classes of shares entitled to preferential dividends have been fully paid. \textit{Id.} § 46(c). Further, no such distribution shall be made to the holders of any class of shares which would reduce the remaining net assets of the corporation below the aggregate preferential amount payable in the event of involuntary liquidation to the holders of shares having preferential rights to the corporation’s assets in the event of liquidation. \textit{Id.} § 46(d).

A corporation may distribute cash out of its capital surplus in discharge of any cumulative preferential dividend rights of outstanding shares if at the time of the distribution it has no earned surplus and is not, and would not thereby be rendered, insolvent. \textit{Id.} § 46, para. 2.

\textsuperscript{46} \textit{Id.} § 46(a).
\textsuperscript{47} \textit{Id.} § 6, para. 1. The Act treats restrictions on purchases of shares appearing in a corporation’s articles of incorporation differently than similar restrictions on dividends. The Act gives dividend restrictions the effect and status of a statutory limitation. It awards no such status to restrictions on purchases. \textit{Compare id.} § 6 (purchases of stock) with \textit{id.} § 45 (dividends).

\textsuperscript{48} \textit{Id.} § 6, para. 1.
\textsuperscript{49} \textit{Id.} § 6, para. 4.
\textsuperscript{50} \textit{Id.} § 6, para. 2.
Restrictions on Corporate Distributions

acquisitions made to eliminate fractional shares, collect or compromise indebtedness owed to the corporation, pay dissenting shareholders, or effect the retirement of its redeemable shares by redemption or purchase for an amount not in excess of the redemption price. The Act elsewhere provides that no redemption or purchase of redeemable shares shall be made by a corporation when it is insolvent or when such a redemption or purchase would render it insolvent. Further, no such redemption or purchase may be made if it would reduce the corporation's net assets below the aggregate amount payable to the holders of shares having prior or equal rights to the assets of the corporation upon involuntary dissolution.

The Model Act defines "earned surplus" as follows:

"Earned surplus" means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus.

"Capital surplus" is defined as "the entire surplus of a corporation other than its earned surplus." "Surplus" is defined as "the excess of the net assets of a corporation over its stated capital." "Net assets" is defined as "the amount by which the total assets of a corporation exceed the total debts of the corporation." "Stated capital" is defined as follows:

"Stated capital" means, at any particular time, the sum of (1) the par value of all shares of the corporation having a par value that have been issued, (2) the amount of consideration received by the corporation for all shares of the corporation without par value that have been issued, except such part of the consideration therefor as may have been allocated to capital surplus in a manner permitted by law, and (3) such amounts not included in clauses (1) and (2) of this paragraph as have been transferred to stated capital of the corporation, whether upon the issue of shares as a share dividend or other-

51. It is not clear why the exception extends beyond purchases to other acquisitions. As noted above, only purchases are subject to the surplus limitation and restriction.
52. Id. § 6, para. 3.
53. Id. § 66.
54. Id. § 2(m). Section 2(i) goes on to provide that earned surplus includes "any portion of surplus allocated to earned surplus in mergers, consolidations or acquisitions of all or substantially all of the outstanding shares or of the property and assets of another corporation, domestic or foreign." Id.
55. Id. § 2(k).
56. Id. § 2(i).
57. Id. § 2(i).
wise, minus all reductions from such sum as have been effected in a manner permitted by law. 58

"Insolvent" is defined as the "inability of a corporation to pay its debts as they become due in the usual course of its business." 59 Earned surplus becomes "reserved" by a resolution of the corporation's board of directors to that effect. 60 Earned or capital surplus becomes "restricted" when it is used to measure a corporation's ability to repurchase its own shares and remains "restricted" as long as such shares are held as "treasury shares." 61 "Treasury shares" are defined as "shares of a corporation which have been subsequently acquired by [it], and have not . . . been cancelled or restored to the status of authorized but unissued shares." 62

The procedure for and limitations upon reduction of a corporation's stated capital depend on the type of reduction proposed. Redeemable shares are cancelled when purchased or redeemed by the corporation. 63 Other shares reacquired by a corporation, including shares repurchased and shares contributed by shareholders, 64 may be cancelled by resolution of the corporation's board of directors. 65 In either case, upon the filing by the secretary of state of a statement of cancellation, stated capital is reduced by that part of the stated capital represented by the shares cancelled. 66

Where stated capital is to be reduced by reducing the aggregate par value of shares having par value or the aggregate of stated capital allocated to shares without par value, 67 the Model Act requires that the procedure for amending the corporation's articles of incorporation 68 (i.e.,

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58. Id. § 2(j). The subsection also contains an additional sentence discussing the determination of the stated capital of foreign corporations for purposes of computing various fees and charges imposed by the Act.
59. Id. § 2(n).
60. See id. § 70, para. 4. To the extent so reserved, such surplus is not available for the payment of dividends. Presumably, "reserved" capital surplus arises from similar action by the directors. Directors may abolish such reserves by adopting a resolution to that effect.
61. Id. § 6, para. 2.
62. Id. § 2(h). The definition also states that "treasury shares" are deemed to be "issued" shares, but not "outstanding" shares.
63. Id. § 67.
64. The Comment of the Committee on Corporate Laws to § 68 states that "non-redeemable shares are ordinarily reacquired only through purchase." 2 Model Business Corp. Act Ann. §§ 67, 68 ¶ 2 (2d ed. 1971). It is clear, however, that "reacquired" encompasses types of transfers beyond "purchases." See Model Business Corp. Act § 6 (1979).
66. Id. §§ 67, 68.
67. See id. § 58(e), (h), (i).
68. See 2 Model Business Corp. Act Ann. § 8 ¶ 2 (2d ed. 1971) (comment of the Committee on Corporate Laws) which requires "substantial compliance in good faith with the corporate pro-
Restrictions on Corporate Distributions

adoption of a resolution by the directors, notice to the shareholders, and approval by the holders of a majority of shares entitled to vote thereon) be followed. Such a reduction is effected when the articles of amendment have been issued by the secretary of state. Finally, amounts transferred voluntarily to stated capital may be reduced upon adoption of a resolution by the directors to that effect, approval by holders of a majority of shares entitled to vote on the issue, and filing with the secretary of state of a statement of reduction. This last type of reduction of stated capital may not be made if it would reduce the corporation's aggregate stated capital to an amount equal to or less than the aggregate preferential amounts payable upon issued shares having a preferential right in the corporation's assets in the event of involuntary liquidation plus the aggregate par value of all other issued shares having a par value.

Any surplus created by a reduction of stated capital is capital surplus. A corporation may, by resolution of its board of directors, apply capital surplus to reduce or eliminate any deficit in earned surplus arising from losses, however incurred.
Directors who vote for, or assent to, the declaration of any dividend or other distribution of corporate assets to shareholders contrary to the Model Act provisions or contrary to any restrictions in the corporation's articles of incorporation, and who have not met the Act's standard of performance for the duties of directors in such action, are jointly and severally liable to the corporation for the amount of the illegal dividend. Similarly, directors who vote for, or assent to, the purchase of the corporation's own shares contrary to the Model Act provisions, and who have not met the Act's standard of performance for directors in such action, are jointly and severally liable to the corporation for the consideration illegally paid for such shares. Any director held liable on a claim for the payment of a dividend or other distribution of assets under these provisions is entitled to contribution from shareholders who accepted or received any such dividend or assets knowing the dividend or distribution was made in violation of the Act. Any director against whom a claim is asserted under these provisions is entitled to contribution from other directors who voted for or assented to the action upon which the claim is asserted.


The pre-1980 Model Act provisions result in the imposition of substantial costs on all corporations incorporated in any Model Act jurisdiction, issued shares of any class into a greater number of shares of the same class without increasing the corporation's stated capital is not a dividend of shares for purposes of the provisions above. Id. § 45.

A director's assent is presumed if the director is present at a meeting at which directors' action is taken, unless the director's dissent is entered or filed in specified ways. See id. § 35, para. 3.


Id. § 48(a). While the Act posits liability for dividend or distribution declarations in violation of law, the amount for which directors may be liable is the amount of such dividend which is paid or the value of such assets which are distributed in excess of the amount of such dividend or distribution which could have been paid or distributed without a violation of the provisions of this act or the restrictions in the articles of incorporation. Id. (emphasis added).

Although the statute is not clear on the question, shares redeemed by a corporation in violation of the Act's provisions also presumably result in such liability.

Id. § 48(b). Note that apparently directors are not entitled to contribution from shareholder-recipients of an illegal share repurchase, even if they knew that the purchase was made in violation of the Act.

Id. § 48, para. 3. It is not clear why this provision is triggered by only the assertion of a claim, rather than by the director being held liable, as is the case with the shareholder contribution paragraph.
on the shareholders and creditors of such corporations, and on any courts called upon to adjudicate controversies involving the provisions.\textsuperscript{83}

Under these provisions, each corporation incorporated in a Model Act state requesting certification of its financial statements by a public accountant must bear the cost of determining the appropriate accounting treatment\textsuperscript{84} for transactions that affect its shareholders' equity accounts.\textsuperscript{85} Such cost would appear to be a significant factor only for corporations that frequently engage in complex transactions with shareholders,\textsuperscript{86} or that have numerous subsidiaries.\textsuperscript{87}

\textsuperscript{83} The provisions may also cause some loss of revenue for governmental units that tax income. The provisions are more permissive toward share repurchases (which are typically taxed at a lower rate than dividends, see Kummert, \textit{supra} note 10, at 360–61) than toward dividends. Repurchased shares can be cancelled under § 68 of the Model Act, with the result that surplus of some type, see \textit{infra} note 104, equal to the par or stated value of the shares is created. Thus, a share repurchase at a price equal to or less than the par value of the shares, followed by cancellation of the shares, can be repeated until the insolvency limitation is encountered—in effect recycling (or increasing if the purchase price is less than par) the surplus used to support the first repurchase. With a dividend distribution, surplus is reduced at the time of payment. See \textit{Model Business Corp. Act} § 45 (1979).

The amount of revenue that may be lost because of the more permissive share repurchase provisions is hard to gauge. The condition required for surplus recycling (or creation)—a purchase price equal to or less than the par or stated value of the shares—is not likely to exist often because of increases in the value of the shares due to inflation or because of the use of minimal par or stated values at the time of issuance. Share repurchases also tend to be more expensive to consummate than dividend payments. See \textit{infra} note 95, and text accompanying notes 94–113. In addition, the governmental units may vary the tax on periodic redemptions. See Kummert, \textit{supra} note 10, at 361 n.10.

\textsuperscript{84} Determining the appropriate accounting treatment of transactions affecting shareholders' equity appears to be a complex matter. Accounting authorities state that if a state statute prescribes the accounting treatment for a transaction affecting shareholders' equity, accounting should conform to the law. See \textit{Financial Accounting Standards Board, Accounting Standards, Original Pronouncements Issued Through June 1973}, at 126 (1983) (APB Opinion No. 6, ¶ 13, issued Oct. 1965) [hereinafter cited as \textit{FASB Accounting Standards, June 1973}]. \textit{But see B. Melcher, Stockholders' Equity, Accounting Research Study No. 15}, 120–21, 136 (1973) (recommending that legal requirements not be controlling in the financial reporting of such transactions). On the other hand, if the statute does not provide accounting treatment for a transaction (and note that the Model Act provisions discussed above make very few prescriptions for such treatment), the laws of the state of incorporation are simply one of a series of factors used in determining the appropriate accounting for such transactions. See B. \textit{Melcher, supra}, at 81–86.


\textsuperscript{86} Such transactions would be, for example, frequent repurchases of shares from shareholders, followed by resale, distribution, or cancellation of the reacquired shares. The accounting problems involved in such transactions are discussed in Kummert, \textit{Financial Provisions (pt. 3)}, \textit{supra} note 77, at 382–90.

\textsuperscript{87} The accounting problems involved in such a situation are discussed in Kummert, \textit{Financial Provisions (pt. 2)}, \textit{supra} note 85, at 161–68. Since that discussion was published, accounting rules have been modified to require equity accounting in any case where the investing corporation has significant influence (presumed to occur if the corporation owns 20% or more of the voting power of another corporation) over the operating and financial policies of an investee. See \textit{FASB Accounting Standards, June 1973}, \textit{supra} note 84, at 262 (APB Opinion No. 18, ¶ 17, issued March 1971).
Most of the Model Act corporations wishing to obtain a large or long-term loan must pay the costs related to covenants in loan agreements required by creditors not satisfied with the protection afforded them by the Model Act provisions against excessive distributions. The initial cost of inserting a typical protective covenant into a loan agreement does not appear to be significant. But even when great care is expended in drafting the covenant, the corporation and its lender are likely to incur significant costs with some frequency related to determining the effect of unusual

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88. The survey in Kummert, supra note 10, at 374 n.63, of the terms of such provisions in loan agreements entered into by large corporations indicated that 12 of the 100 corporations surveyed had long-term debt but were apparently strong enough financially that no covenants or security devices were required by the lender. A smaller sample indicated that most preferred stock agreements do not contain such covenants. Id. To the extent such agreements contain protective covenants, the text paragraph should be extended to issuances of preferred shares, as well as long-term loans.

89. In the survey discussed in Kummert, supra note 10, at 374 n.63, the language limiting distributions to earnings after a "peg-date" and to conditions of specified liquidity varied little between corporations. Indeed, most covenants were quite similar to the specimens in AMERICAN BAR FOUNDATION, CORPORATE DEBT FINANCING PROJECT, COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS § 10-12 (1971). This is not to say that drafting of such covenants can or should stop with "form" language, because such matters as defining "net earnings" for such purposes are difficult, time-consuming issues that ought to be resolved only after careful analysis of the debtor’s major income sources, and the pattern of expenditures to obtain such revenue. See B. MANNING, supra note 9, at 106.
transactions on the operation of the covenant. And on some occasions, litigation may be necessary to resolve such questions, with significant costs for the corporation and lender involved.

Almost all of the Model Act corporations considering a proposed financial distribution to shareholders must bear the cost of determining whether the distribution can be made without violating the provisions. This cost should not be large if the corporation’s surplus and cash-flows, the size and type of the distribution, and the relevant statutes and cases are such as to permit counsel to render a short, affirmative opinion on the proposed distribution. If, however, counsel has reasonable doubt about the validity of a proposed distribution, the cost to the corporation may be quite large, both absolutely and in comparison to the size of the proposed distribution.

Consider, for example, the costs involved for a small corporation in consummating an installment repurchase of shares—a type of distribution that recent litigation concerning financial distributions suggests is both common and fraught with doubt about its legal validity. Counsel for a

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90. Thus, in Ramo, Inc. v. English, 500 S.W.2d 461 (Tex. 1973), the issue was whether "advances" from a subsidiary to its parent corporation constituted a "dividend" for purposes of a covenant in a loan agreement entered into by the parent corporation. On the general subject of the interpretation of the language in such indentures, see Morgan Stanley & Co. v. Archer Daniels Midland Co., 570 F. Supp. 1529 (S.D.N.Y. 1983).


92. The controversy in Ramo, Inc. v. English, 500 S.W.2d 461 (Tex. 1973) had been the subject of a jury trial, a court of appeals decision, and a state supreme court decision.

93. It would appear that the only corporations considering a distribution that might not have to bear this cost are those subject to loan covenants more restrictive than the statutory provisions. In such situations, the covenants become the operative provisions. But even in these situations, careful counsel may determine the validity of the distribution under the statutory provisions on the off-chance that the distribution might be acceptable under the covenant but not pass the statutory provisions. See Kummert, supra note 10, at 395 n.161.

94. See id. at 394 n.157, which indicates that over half (52) of all cases (96) involving state financial provisions since 1946 that did not impose or suggest liability for directors or shareholders concerned installment repurchases of shares. In addition, at least three of the cases imposing liability on directors or shareholders involved installment repurchases. See Steph v. Branch, 255 F. Supp. 526 (E.D. Okla. 1966), aff’d, 389 F.2d 233 (10th Cir. 1968); Cunningham v. Jaffe, 251 F. Supp. 143 (D.S.C. 1966); Gray v. Sutherland, 124 Cal. App. 2d 280, 268 P.2d 754 (1954).

The hypothesis in the text as to the most common question presented to counsel can also be supported by the sheer number of small corporations in the United States and by the distinct tax advantages for a selling shareholder in receiving funds from the corporation in the form of an installment repurchase of shares. The great bulk of corporations in the United States can appropriately be labeled "small." For example, of 2,710,538 active corporation income tax returns filed with the Internal
corporation considering a proposed installment repurchase often must resolve most of the following issues raised by the Model Act provisions: (a) how the Act’s insolvency test applies to installment repurchases of shares; (b) whether application of the insolvency test is affected by the corporation’s issuance of a negotiable instrument as evidence of, or a

Revenue Service for the tax year 1980, 2,298,004, or approximately 85%, had assets under $500,000. Over half of such active corporations’ returns showed corporate assets under $100,000. See U.S. Dept. of Treasury, Internal Revenue Serv., Corporation Income Tax Returns, 1980 Statistics of Income 2 (1983). An installment repurchase meeting the requirements of §§ 302(b) and 453 of the Internal Revenue Code provides the selling shareholder with the advantage of reporting a proportion of the total long-term capital gain in each tax year a principal payment is made. I.R.C. §§ 302(b), 453 (1976 & Supp. V 1981). Such advantage is preferred by most shareholders over a dividend distribution of the same number of dollars. See Kummert, supra note 10, at 367–68 nn. 36–37.

95. A repurchase of shares for cash would reduce the issues discussed infra text accompanying notes 96-111, only by issues (a)-(c).

A proposed dividend would also raise a number of similar legal issues. Thus, counsel may have to determine: (a) what valuation standard is to be used in determining the value of the corporation’s assets, and thus its surplus; (b) if current value is considered to be the appropriate valuation standard, what approach to determining current value is to be used, and what type of surplus results from the corporation’s recognition of unrealized appreciation; (c) if the accounting approach to asset valuation is considered to be the appropriate valuation standard, whether numerous transactions potentially affecting the corporation’s surplus accounts have been appropriately treated for purposes of the application of the Model Act provisions; (d) what steps must be taken in the event it is necessary to reduce the corporation’s stated capital; and (e) what constitutes reasonable care by directors in effecting the dividend.

96. It may not be clear at first glance why some of the issues raised in the text present problems for the corporation repurchasing the shares. The corporate interest in such transactions stems from the determination by a board of directors that a repurchase of shares is a necessary step for the corporation to take. Once that determination is made, the transaction must be arranged by corporate counsel so that the possibility of liability for directors is minimized and that the legal incidents of the transaction for the selling shareholder and for the corporation are acceptable to each. A case can be made for allocating the expense of the latter inquiry between the selling shareholder and the corporation; however, it seems doubtful that such allocations will be made unless the issue is of relevance almost exclusively to the shareholder. The only issue discussed in the text that appears to fit within that category is whether application of the insolvency test is affected by the use of a negotiable instrument or a security device. Thus, almost all of the expense in connection with such transactions will likely be borne by the corporation.

97. Model Business Corp. Act § 6, para. 4 (1979) states: “No purchase of or payment for its own shares shall be made at a time when the corporation is insolvent or when such purchase or payment would make it insolvent.”

98. Herwitz, Installment Repurchase of Stock: Surplus Limitations, 79 Harv. L. Rev. 303, 322 (1965), argues that the words “or payment for” were added in 1957 to the last paragraph of § 6 of the Model Act to ensure that the insolvency test is imposed both at the time the installment obligation is entered into and at the time each payment in discharge of the obligation is made. This position is in accord with common law authorities, see id. at 308–11, and seems accepted by recent decisions. See Neimark v. Mel Kramer Sales, Inc., 102 Wis. 2d 282, 306 N.W.2d 278, 283 (1981) (dictum). But see Libco Corp. v. Leigh (In re Reliable Mfg. Co.), 703 F.2d 996 (7th Cir. 1983) (involving Delaware law).

99. See Williams v. Nevelow, 513 S.W.2d 535, 539 (Tex. 1974) (dictum) (issuance of a secured negotiable instrument could be considered “payment” for the repurchased stock).
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security device in support of, its obligation to make deferred payments; (c) how the Act’s surplus measurement test applies to installment repurchases of shares; (d) whether capital surplus may be used as the measure for a share repurchase even though the corporation also has earned surplus; (e) how the corporation’s surplus is affected if the reacquired shares are cancelled; (f) what valuation standard is to be used in

100. Courts in Model Act jurisdictions have not addressed this question. The authorities in other jurisdictions are divided. See Walsh v. Paterna (In re National Tile & Terrazzo Co.), 537 F.2d 329 (9th Cir. 1976) (lien arising from a deed of trust issued to secure an installment repurchase by a California corporation of shares covered at the outset by adequate earned surplus is not rendered ineffective by the later insolvency of the corporation and failure of the underlying installment note); accord Tracy v. Perkins-Tracy Printing Co., 278 Minn. 159, 153 N.W.2d 241 (1967) (based on Minnesota statute). But see Reiner v. Washington Plate Glass Co., 711 F.2d 414, 417 (D.C. Cir. 1983) (“the security falls with the underlying obligation”); Gold v. Lippman (In re Flying Mailman Serv., Inc.), 539 F.2d 866 (2d Cir. 1976) (based on New York statute, holding later insolvency voids the lien). Earlier authorities are reviewed in Annot., 4 A.L.R. FED. 654 (1970).

Courts in Model Act jurisdictions are divided on the analogous question of the effect to be given to a shareholder’s guarantee of a corporation’s repurchase obligation where it is determined that such repurchase is contrary to law. Compare Field v. Haupert, 58 Or. App. 117, 647 P.2d 952 (1982) (corporation’s repurchase of stock while insolvent held illegal, not ultra vires, and illegality was a complete defense to shareholder’s liability under the guarantee) with James v. J.F.K. Carwash, Inc., 275 Ark. 141, 628 S.W.2d 299 (1982) (corporation’s promissory note given for repurchase of stock when it had no earned surplus held ultra vires, not void, and none of the conditions for shareholder’s assertion of ultra vires defense were present).

101. MODEL BUSINESS CORP. ACT § 6, para. 1 (1979). This section states: [P]urchases of [a corporation’s] own shares, whether direct or indirect, shall be made only to the extent of unreserved and unrestricted earned surplus available therefor, and, if the articles of incorporation so permit or with the affirmative vote of the holders of a majority of all shares entitled to vote thereon, to the extent of unreserved and unrestricted capital surplus available therefor.

102. Compare Fisk v. Newsum, 9 Wn. App. 650, 513 P.2d 1035 (1973) (apparently interpreting the Washington (Model) Act language to mean that the surplus measurement test is to be applied as each principal payment is made) with Neimark v. Mel Kramer Sales, Inc., 102 Wis. 2d 282, 306 N.W.2d 278, 284-85 (1981) (holding that the Wisconsin (Model) Act surplus test is to be applied at the time of purchase).

103. MODEL BUSINESS CORP. ACT § 6 (1979) does not specify that a share repurchase shall be first measured against existing earned surplus. The Act also does not require notice to be provided to the selling (or remaining) shareholders when shares to be repurchased will be measured against capital surplus. Such notice is required when distributions of cash or property are made out of capital surplus, see id. § 46(e). The requirement of notice on distributions out of capital surplus and lack thereof on share repurchases measured against such surplus would seem to encourage corporations to measure share repurchases against capital surplus whenever possible. Such accounting for the transaction may provoke a reaction from the SEC and from some accountants. See L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 18.32-33 (3d ed. 1972).

104. Assuming the repurchase price is equal to the par value of the shares, the issue is whether the reduction of stated capital resulting from the cancellation of the reacquired shares has the effect of restoring the earned surplus restricted on the acquisition to unrestricted earned surplus, or of increasing capital surplus (while earned surplus is reduced by an equivalent amount). On the issue, compare D. HERWITZ, BUSINESS PLANNING 425-26 (1966) and Sprouse, Accounting for Treasury Share Transactions: Prevailing Practices and New Statutory Provisions, 59 COLUM. L. REV. 882, 892-93 (1959) (both arguing that the effect of such a cancellation is to create capital surplus equal to the par value of the shares cancelled, and to reduce earned surplus by an amount equal to the purchase price) with
determining the value of the corporation’s assets, and thus its surplus; if current value is considered to be the appropriate valuation standard, what approach to determining current value is to be used and what type of surplus results from the corporation’s recognition of unrealized appreciation; (h) if the accounting approach to asset valuation is considered to be the appropriate valuation standard, whether numerous transactions potentially affecting the corporation’s surplus accounts have been matched to the appropriate surplus account for purposes of the application of the Model Act provisions; (i) how these questions are affected if the acquiring corporation is acquiring its own shares and has subsidiaries, or if the acquiring corporation is a subsidiary corporation acquiring its parent’s shares; and (j) what constitutes reasonable care by directors in effecting such a transaction. If counsel decides that current value is the


Other issues of almost equal complexity arise if the shares are resold for a price different than the repurchase price, or if they are declared as a share dividend. See Hackney, *supra*, at 1394-97.


Corporations writing up assets to reflect current fair market value may incur significant costs apart from lawyers’ fees. See infra text accompanying note 180–84.


111. As noted supra text accompanying note 80, a director who votes for or assents to the purchase of the corporation’s own shares contrary to the provisions of the Act is liable to the corporation jointly and severally with all other directors so voting or assenting for the amount of the distribution that is illegal unless he or she complies with the standard prescribed in the Act for the performance of duties of directors. Section 35 of the Model Act requires a director to perform the duties of a director in good faith in a manner he or she reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. *Model Business Corp. Act* § 35, para. 2 (1979). Section 35 further states:

In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:
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valuation standard for assets, the corporation is likely to incur additional costs for studies by appraisers or accountants, or internal financial studies. Regardless of the resolution of the asset valuation issue, the corporation must incur the cost of an analysis of its short-term cash flows sufficient to illuminate the effect of the proposed repurchase on its ability to meet its debts as they become due in the ordinary course of business. Finally, a substantial amount of directors’ time will presumably be expended analyzing lawyers’, appraisers’, and accountants’ opinions, data on cash flows, and the extent of directors’ liability if the distribution is subsequently found to have violated the statutory provisions.

The directors of some Model Act corporations, or, in the case of proposed repurchases of shares, some potential selling shareholders, after considering the costs involved in determining the validity of a proposed distribution and its unavoidable risks, may decide not to make a distri-

(a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,

(b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person’s professional or expert competence, or

(c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incorporation or the by-laws, as to matters within its designated authority, which committee the director reasonably believes to merit confidence,

but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted.

Counsel may be called upon to advise directors as to the relationship of the reliance-on-information sentence to the general duty of care, and as to the meaning of such terms as “good faith,” “care,” “prudent person,” and “reasonably believes.”

That is, whether the payments required for the proposed repurchase can be made without violating the insolvency limitation. See supra note 97.

On the determination of whether a distribution will render the corporation equitably insolvent, see the helpful comment of the ABA Committee on Corporate Laws, infra note 318, and Murphy, Equity Insolvency and The New Model Business Corporation Act, 15 U. Richmond L. Rev. 839, 855–71 (1981). Murphy raises, but does not resolve, a question counsel may have to address in providing instructions to persons gathering the cash-flow information: how long after the distribution must a corporation be solvent in order to escape operation of the statute?

It appears that a claim against directors for an illegal distribution would be covered by a typical directors’ and officers’ liability insurance policy. See Comiskey, Directors’ and Officers’ Liability Insurance—A Hypothetical Case, 43 Ins. Counsel J. 34, 50–54 (1976). It is not clear whether the possibility of such claims, given their infrequency, would increase the cost of such insurance.

By virtue of the director liability provisions in Model Business Corp. Act §§ 35, 48 (1979), and the courts’ general reluctance to find directors liable for breach of the duty of care, see, e.g., Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L.J. 1078 (1968), directors have only a very small risk of liability on any distribution in relation to which they rely in good faith on supportive opinions of counsel and an appraiser. As previously noted, supra note 81, apparently even knowing recipients of an illegal share repurchase are not liable for contribution to any director found liable on such repurchase. However, such provisions may not prevent a court from imposing liability on such shareholders for the benefit of creditors. See Reilly v. Segert, 31 Ill. 2d 297, 201 N.E.2d 444 (1964) (so holding under Illinois statute). Moreover, a shareholder making an installment sale of shares in the corporation has a much

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bution that would have been beneficial to most of the parties connected with the corporation. The costs resulting from such decisions, apart from the fees incurred to the point of abandonment, are likely to be hard to measure. Such costs may prove to be significant, however, if the abandoned distribution was a repurchase of shares by a small corporation and disharmony later develops between the shareholder desiring to leave the corporation and the corporation’s managers.

Model Act corporations, and their directors, shareholders, and creditors, participating in disputes over the impact of these provisions on proposed or consummated transactions, are likely to bear increased costs in settling or litigating the disputes simply because of the complexity and ambiguity of the provisions. While a limited number of such contro-

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115. In a publicly held corporation, a decision not to distribute a dividend warranted by financial considerations will hurt shareholders with a preference for current distributions and may communicate inappropriate information about the corporation’s prospects to shareholders or prospective shareholders for whom such information is an important factor in buying and selling shares. See Kummert, supra note 10, at 366–68. Shareholders with a preference for retained earnings, senior security holders, trade creditors, and employees are likely to favor the decision not to distribute. See id. at 366–68, 373–76. Management will find its flexibility in making decisions impeded by the legal constraints. See id. 376–79.

Because of the significant tax benefits to the corporation and its shareholders of share repurchases and salaries as compared to dividends, see id. at 360–61, it appears that a decision even to consider distributing a dividend to the shareholders of a closely held corporation would be due to anticipation of unique benefits to shareholders from the distribution (e.g., a return-of-capital distribution from a corporation with no current or accumulated earnings and profits under I.R.C. §§ 301 & 316 (1976 & Supp. V 1981)). Such shareholders will lose the prospective benefit as a result of the decision not to distribute. But senior security holders, trade creditors, and employees of such a corporation are likely to favor the decision.

116. A decision by a publicly held corporation not to repurchase shares when such distribution is supportable by financial factors, see Kummert, supra note 10, at 381–91, will generally harm the shareholders who would have sold their shares, and in some cases the remaining shareholders. Senior security holders, trade creditors, and employees of the corporation would appear to prefer that the corporation retain the funds, with the possible exception of a repurchase of shares held by shareholders when the costs of servicing such shareholders are excessive. See id. at 388–89. Management will again find its flexibility impeded by legal constraints.

117. If such disharmony causes the corporation to be less profitable than it would have been had the shareholder’s stock been repurchased, it appears that all parties connected with the corporation lose, with the possible exception of trade creditors. Even they may lose if the disharmony ultimately leads to the corporation’s insolvency. It seems unlikely that parties faced with significant losses will be unable to fashion a method for removing the disruptive shareholder.

118. The increase in costs may be no more than the cost of dealing with another argument or claim in a complicated proceeding which would have produced a controversy even if the state had no statutory provisions on distributions. See, e.g., Georesearch, Inc. v. Morriss, 193 F. Supp. 163 (W.D. La. 1961) (involving a series of challenges to stock transfer restrictions), aff’d per curiam, 298 F.2d 442 (5th Cir. 1962). On the other hand, the argument or claim involving the state distribution restrictions may be the central issue in the controversy, and thus the primary factor giving rise to
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verses are likely to be resolved by litigation, the disputes finally presented to courts seem certain to require extra trial and appeal time for the resolution of ambiguities in the provisions.

Current or prospective shareholders of publicly held Model Act corporations attempting to gauge prospects for the corporation's share prices from changes (or lack thereof) in the corporation's dividend rate may suffer investment losses or bear additional information costs because of the complete lack of relationship between the amount of dividends permissible under the Act and the corporation's recent earnings performance.

Common shareholders of Model Act corporations with more than one class of shares attempting to reduce stated capital and thereby create capital surplus may be forced to yield unreasonable concessions to holders of preferred or special classes of shares in order to obtain the necessary approval by classes of shares for the reduction.


The costs set forth above appear to exceed by far the limited benefits that either the groups interested in the amount of corporate financial distributions or the groups involved in the administration of the legal limitations receive from the operation of the provisions.


See Kummert, supra note 10, at 394 nn.156-57 (indicating only 126 cases have involved the corporation law restrictions since 1946).

Further litigation and court costs may result if lawyers or accountants involved in advising the parties on the distribution are later charged with malpractice concerning that advice. See, e.g., Fisk v. Newsam, 9 Wn. App. 650, 513 P.2d 1035 (1973).

The difficulties in a shareholder accurately making such a prediction are discussed in Brudney, supra note 13, at 109-14.

The shareholders' task in this respect is not made any easier by virtue of the notice provided to shareholders under § 46(e) of the Model Act concerning each distribution made by a corporation from capital surplus. MODEL BUSINESS CORP. ACT § 46(e) (1979). Such notice would provide important information to shareholders only if the distribution was being made because management believed the corporation's future prospects were bright. Instead, it seems likely that many such distributions reflect management's desire either to pacify shareholders or to liquidate part of the corporation.

Such costs are one factor leading Professor Brudney to suggest that management should be required to disclose the basis for each dividend action taken by a publicly held corporation. Brudney, supra note 13, at 114-29.

It should be noted that it is precisely because of this lack of relationship that shareholders desiring a stable dividend rate receive the benefit they desire under the Act. See infra text accompanying note 126.

See B. Manning, supra note 9, at 88.

It seems likely that a reduction of stated capital attributable to either the preferred or special class of shares or the common shares will give the holders of the preferred or special shares a class vote under MODEL BUSINESS CORP. ACT § 60(e) (1979). See D. Herwitz, supra note 104, at 362-65.
The Model Act provisions permit corporations to maintain stable dividend rates despite recent adverse earnings performance. Shareholders of publicly held corporations appear to attach significant value to such stability, and national economic policy may be aided in times of depression if significant numbers of corporations maintain dividend rates in the face of declining earnings.

The Model Act provisions prohibit all types of financial distributions to shareholders by corporations that would be unable to pay their debts as they arise in the usual course of business after the distribution. Trade creditors of both publicly held and closely held corporations attach considerable importance to such protection.

The Model Act provisions cause corporations, and their creditors, and shareholders, to expend significant amounts for the advice of lawyers, accountants, and possibly appraisers on matters related to the operation of the provisions. Such groups can thus be said to benefit significantly from the existence of such provisions.

In view of the relative imbalance of costs and benefits resulting from the operation of the Model Act provisions, it would appear that legislatures in Model Act states should consider alternate provisions, and that legislatures in other states should consider the pre-1980 Model Act provisions only if their provisions result in greater cost-benefit imbal-

126. See Kummert, supra note 10, at 370–71.
127. See id. at 364.
128. The insolvency limitation is applied to dividends out of earned surplus, MODEL BUSINESS CORP. ACT § 45(a) (1979), dividends out of depletion reserves, id. § 45(b), distributions out of capital surplus, id. § 46(a), purchases of or payments for a corporation's shares, id. § 6, para. 4, and redemptions or purchases of redeemable shares, id. § 66.
129. See Kummert, supra note 10, at 375–76.
130. B. MANNING, supra note 9, at 108, seems to suggest that lawyers, accountants, law students, and teachers have a net cost as a result of the operation of the provisions. It seems doubtful that most lawyers and accountants will expend significant amounts of time studying such provisions absent questions presented by a paying client. Law teachers and law students currently expend the time to study such provisions in major part because of the demand for lawyers with such skills.

It should also be noted, however, that at least two states that have made recent major revisions in their corporation statutes have moved to the pre-1980 Model Act provisions. See IDAHO CODE §§ 30-1-6, -45, -46, -66 (Supp. 1982–83); N.H. REV. STAT. ANN §§ 293-A:6, :45, :46, :66 (Supp. 1983).
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ances than those resulting under the Model Act. Subsequent analysis will show that no set of provisions results in such imbalance.

b. The Balance Sheet Surplus Approach

Sixteen states\textsuperscript{133} and the District of Columbia\textsuperscript{134} use balance sheet surplus as the central concept in their regulation of financial distributions by corporations to shareholders. The provisions in the recently adopted Michigan Business Corporation Act\textsuperscript{135} are exemplary of the statutory systems using this approach and provide a suitable vehicle for analyzing the costs and benefits of this system.


A Michigan corporation may declare and pay dividends or make other distributions on its outstanding shares in cash, bonds,\textsuperscript{136} or property, including the shares or bonds of other corporations. It may not take any of such actions when the corporation is insolvent or would thereby be made insolvent, nor when the proposed action would be contrary to any restriction contained in the corporation’s articles of incorporation.\textsuperscript{137}


\textsuperscript{137} Id. § 450.1351(1) (Mich. Stat. Ann. § 21.200(351)(1)).
may be declared or paid, and other distributions may be made, only out of surplus.\textsuperscript{138} A dividend paid or any other distribution made in any part from sources other than earned surplus must be accompanied by a written notice disclosing the amounts by which the dividend or distribution affects stated capital, capital surplus, and earned surplus.\textsuperscript{139}

A Michigan corporation generally may purchase its own shares only out of surplus.\textsuperscript{140} However, it may purchase its own shares out of stated capital for the purposes of eliminating fractional shares, collecting or compromising indebtedness to the corporation, and paying dissenting shareholders entitled to payment for their shares.\textsuperscript{141} It may also redeem or purchase its redeemable shares out of stated capital, provided that after such a redemption or purchase its net assets at least equal its stated capital remaining after cancellation of such shares.\textsuperscript{142}

A Michigan corporation may not purchase or redeem its own shares under the following conditions: (a) when such action would be contrary to a restriction contained in its articles of incorporation; (b) when the corporation is insolvent or by such action would be rendered insolvent; (c) unless after the purchase or redemption there remain outstanding one or more classes or series of shares possessing among them voting rights and unlimited residual rights to dividends and distribution of assets on liquidation; and (d) in the case of redeemable shares and within the period of their redeemability, if the price to be paid is greater than the applicable redemption price plus, in the case of shares entitled to cumulative dividends, the dividends which would have accrued to the next dividend date following the purchase or redemption.\textsuperscript{143}

\textsuperscript{138} \textit{Id.}

\textsuperscript{139} \textit{Id.} \textsection 450.1351(3) (Mich. Stat. Ann. \textsection 21.200(351)(3)). If the amounts by which the dividend or distribution affects stated capital, capital surplus, and earned surplus are not determinable at the time the dividend is paid or distribution is made, the notice must disclose the approximate effect of the dividend or distribution upon such accounts and state that precise effects are not yet determinable.

\textsuperscript{140} \textit{Id.} \textsection 450.1365(1) (Mich. Stat. Ann. \textsection 21.200(365)(1)).

\textsuperscript{141} \textit{Id.} \textsection 450.1366(1) (Mich. Stat. Ann. \textsection 21.200(366)(1)).

\textsuperscript{142} \textit{Id.} \textsection 450.1366(2) (Mich. Stat. Ann. \textsection 21.200(366)(2)). Subject to the limitation noted in text accompanying this note, a corporation may also purchase its nonredeemable shares out of stated capital if such shares have a preference over the shares of any other class or series in payment of dividends or in distribution of assets upon liquidation. \textit{Id.} \textsection 450.1366(3) (Mich. Stat. Ann. \textsection 21.200(366)(3)).

\textsuperscript{143} \textit{Id.} \textsection 450.1365(2) (Mich. Stat. Ann. \textsection 21.200(365)(2)). The placement of the four limitations in subparagraph (2) of \textsection 365 leaves open the argument that purchases of shares out of stated capital permitted under \textsection 366 are not subject to the limitations. It does not appear that such result was intended. The limitations in subparagraph (2) of \textsection 365 also apply to redemptions of redeemable shares, which are regulated by subparagraph (2) of \textsection 366. \textit{Id.} \textsection\textsection 450.1365(2), 1366(2) (Mich. Stat. Ann. \textsection\textsection 21.200(365)(2), (366)(2)). The source provision for both sections, N.J. Stat. Ann. \textsection 14A:7-16 (West 1969), combines the material in \textsection\textsection 365-67 of the Michigan Act into a single section and apparently applies the limitations to all purchases.

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A Michigan corporation which has purchased its own shares out of surplus may defer payment for the shares over a period agreed to by it and the selling shareholder. The obligation so created constitutes an ordinary debt of the corporation and the validity of any payment made upon the debt is not affected by the absence of surplus at the time of payment.\textsuperscript{144}

The Michigan Act defines "surplus" as "the excess of the net assets of a corporation over its stated capital."\textsuperscript{145} "Stated capital" is defined as follows:

"Stated capital" means the sum of (a) the par value of all shares with par value that have been issued, (b) the amount of consideration received for all shares without par value that have been issued, except such part of the consideration therefor as has been allocated to surplus in a manner permitted by law, and (c) such amounts not included in classes (a) and (b) as have been transferred to stated capital, whether upon the issuance of shares or otherwise, less reductions from such sum as have been effected in a manner permitted by law.\textsuperscript{146}

"Net assets" is defined as "the amount by which the total assets of a corporation, defined [by statute], exceeds its total liabilities as determined in accordance with generally accepted accounting principles."\textsuperscript{147} "Total assets" is defined as "the total of the properties and rights entered upon the books of a corporation in accordance with generally accepted accounting principles, or the current fair market value of such properties and rights."\textsuperscript{148}

"Earned surplus" is defined as that "portion of the surplus of a corporation that represents the accumulated net earnings, gains and profits, after deduction of all losses, that has not been distributed to shareholders as dividends or transferred to stated capital or capital surplus, or applied to other purposes permitted by law,"\textsuperscript{149} as determined under accounting rules prescribed in another section of the Act.\textsuperscript{150} "Capital surplus" is de-

\begin{itemize}
  \item \textsuperscript{144} MICH. COMP. LAWS § 450.1367 (MICH. STAT. ANN. § 21.200(367) (Callaghan 1983)).
  \item \textsuperscript{145} Id. § 450.1109(4) (MICH. STAT. ANN. § 21.200(109)(4)).
  \item \textsuperscript{146} Id. § 450.1109(3) (MICH. STAT. ANN. § 21.200(109)(3)).
  \item \textsuperscript{147} Id. § 450.1108(1) (MICH. STAT. ANN. § 21.200(108)(1)). The subsection adds that stated capital and surplus are not liabilities. Id.
  \item \textsuperscript{148} Id. § 450.1110(1) (MICH. STAT. ANN. § 21.200(110)(1)).
  \item \textsuperscript{149} Id. § 450.1107(1) (MICH. STAT. ANN. § 21.200(107)(1)). The primary application of such surplus is to the acquisition of treasury shares. See id. § 450.1381(1)(d) (MICH. STAT. ANN. § 21.200(381)(1)(d)).
  \item \textsuperscript{150} Section 381(1)(a) provides that the amount of earned surplus may be computed by a corporation either from the date of formation or from the latest date when a deficit was eliminated by application of the corporation's capital surplus. Id. § 450.1381(1)(a) (MICH. STAT. ANN. § 21.200(381)(1)(a)). However, when two or more corporations consolidate by purchase or other method, the amount of the earned surplus of the surviving corporation must not exceed the aggregate net earned surplus of the component corporations, reduced by distributions to shareholders and trans-
\end{itemize}
fined as "the entire surplus of a corporation other than its earned surplus." 151 ‘Capital surplus’ is intended to include unrealized appreciation of assets resulting from appraisal write-ups of assets. 152

‘Insolvent’ is defined as ‘being unable to pay debts as they become due in the usual course of a debtor’s business.’ 153

‘Treasury shares’ are defined as ‘shares which have been issued, have been subsequently acquired by a corporation, and have not been cancelled. Treasury shares are issued shares, but not outstanding shares, and are not assets.’ 154

Shares reacquired by a corporation out of stated capital are cancelled 155 at the time of reacquisition. 156 Other shares reacquired by a corporation may be retained as treasury shares or may be cancelled by the board of directors at any time. 157

The corporation’s stated capital is not affected by the retention of reacquired shares as treasury shares, the distribution of such shares to shareholders, or the disposition of such shares for consideration. 158 When treasury shares are disposed of for consideration, generally the corporation’s capital surplus is increased by the full amount of the consideration received. 159 However, if the corporation applied earned surplus to the acquisition of the treasury shares, it may restore to earned surplus, out of the consideration received from the disposition and on an appropriate basis per share, any part of the amount by which earned surplus was reduced at the time of acquisition. 160

A corporation’s stated capital is reduced when reacquired shares are

151. See also id. § 450.1342 (Mich. Stat. Ann. § 21.200(342)).

152. See Law Revision Report, supra note 135, at 7–8, 83.


155. Id. § 450.1371(1) (Mich. Stat. Ann. § 21.200(371)(1)). Converted shares, or shares required by the corporation’s articles of incorporation to be cancelled upon reacquisition, are also cancelled. This requirement is not set forth in § 371, but seems implicit in subparagraph (1). See id.


158. Id.

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cancelled.\textsuperscript{161} It may also be reduced by a resolution of the board of directors to eliminate from stated capital amounts previously transferred from surplus to stated capital and not allocated to a designated class or series of shares, to eliminate any amount of stated capital represented by issued shares with par value, to the extent such stated capital exceeds the aggregate par value of such shares, or to reduce the amount of stated capital represented by issued shares without par value.\textsuperscript{162} A reduction of stated capital may not be made through such a resolution unless the stated capital after the reduction exceeds the aggregate preferential amounts payable upon involuntary liquidation upon all issued shares having preferential rights in the assets plus the par value of all other issued shares with par value.\textsuperscript{163} Finally, a Michigan corporation can reduce its stated capital by an amendment to its articles of incorporation which reduces the par value of issued shares having par value, or changes issued shares, with or without par value, into a different number of shares of the same class, or into the same or a different number of shares of any one or more classes or series in a manner that results in a reduction of stated capital.\textsuperscript{164}

\textsuperscript{161} Id. § 450.1372(2) (Mich. Stat. Ann. § 21.200(372)(2)). The amount of the reduction is equal to the amount of stated capital then represented by the shares plus any stated capital not theretofore allocated to a designated class or series which is thereupon allocated to the shares cancelled. Id. The amount of such reduction during a stated period of time must be disclosed to all of the corporation's shareholders in the next financial statement covering such period furnished to the shareholders, or in the first notice of dividend or share distribution furnished to holders of each class or series of its shares, if earlier, but in any case within 15 months after the reduction. Id.

Reacquired shares that are converted shares, and thus cancelled under § 371, are exempted from § 372. See id. §§ 450.1371, 1372 (Mich. Stat. Ann. §§ 21.200(371), (372)). Under § 313, consideration for the shares issued on the conversion of shares shall be any one or more of the following, as determined by the board of directors: the stated capital then represented by the shares converted; any stated capital not theretofore allocated to a designated class or series of shares which is thereupon allocated to the new shares; any surplus transferred to stated capital upon issuance of the shares for the shares converted; or any additional consideration paid to the corporation upon the issuance of shares for the shares converted. Id. § 450.1313 (Mich. Stat. Ann. § 21.200(313)). Thus, if the par or stated value of the shares issued for the shares converted is less than the stated capital represented by the shares converted, and the directors choose the second, third, or fourth sources as consideration for the shares issued in conversion, a reduction of stated capital may result from a conversion of shares.

\textsuperscript{162} Id. § 450.1376(1) (Mich. Stat. Ann. § 21.200(376)(1)). The resolution must state the amount of the proposed reduction, the manner in which the reduction is to be effected, and the date upon which the reduction becomes effective. Id. The amount of any such reduction must be disclosed to shareholders in accord with the time constraints set forth supra note 161. Id. § 450.1377 (Mich. Stat. Ann. § 21.200(377)).

\textsuperscript{163} Id. § 450.1376(2) (Mich. Stat. Ann. § 21.200(376)(2)).

\textsuperscript{164} See Howbert, Corporate Finance, 18 Wayne L. Rev. 979, 995 (1972); Mich. Comp. Laws § 450.1602(e), (h), (i) (Mich. Stat. Ann. § 21.200(602)(e), (h), (i) (Callaghan 1983)). Such reductions are effective at the time the certificate of amendment is endorsed by the state administrator (or such later date, not to exceed 90 days after date of delivery, as is specified in the amendment). Id. § 450.1131(2) (Mich. Stat. Ann. § 21.200(131)(2)); see also id. § 450.1631(2) (Mich. Stat. Ann. § 21.200(631)(2)).
Surplus arising from any reduction of stated capital is capital surplus.\textsuperscript{165} A corporation may, by resolution of its board of directors, apply capital surplus to the reduction or elimination of any deficit in earned surplus.\textsuperscript{166}

Directors of a Michigan corporation who vote for, or concur in,\textsuperscript{167} the declaration of a dividend or other distribution of assets to shareholders,\textsuperscript{168} or purchase of shares of the corporation,\textsuperscript{169} contrary to these provisions or to any restriction in the corporation’s articles of incorporation or by-laws,\textsuperscript{170} and who have not complied with the Act’s standard of performance in so doing,\textsuperscript{171} are jointly and severally liable to the corporation for an amount not to exceed the amount unlawfully paid or distributed.\textsuperscript{172}

\textsuperscript{165} Id. § 450.1381(1)(c) (Mich. Stat. Ann. § 21.200(381)(1)(c)).

\textsuperscript{166} Id. § 450.1381(2) (Mich. Stat. Ann. § 21.200(381)(2)). Any such application of capital surplus must be disclosed to the corporation’s shareholders within six months of the date of such action. Id.

Under Michigan Corporation Law § 355, a corporation, subject to any restriction contained in its articles of incorporation, may pay a dividend in its own shares. Id. § 450.1355 (Mich. Stat. Ann. § 21.200(355)). If the share dividend is paid in authorized but unissued shares, the corporation must transfer to stated capital an amount of surplus equal to: (1) if the dividend is payable in shares having a par value, at least the aggregate par value thereof; (2) if the dividend is payable in shares without par value, the amount fixed as stated capital by the board of directors or shareholders for such shares. Id. § 450.1355(2) (Mich. Stat. Ann. § 21.200(355)(2)). If the share dividend is paid in treasury shares, a transfer from surplus to stated capital need not be made. Id. § 450.1355(3) (Mich. Stat. Ann. § 21.200(355)(3)). A split-up or division of issued shares of a class or series into a greater number of shares of the same class or series without increasing the stated capital of the corporation is not a share dividend for purposes of these provisions. Id. § 450.1355(4) (Mich. Stat. Ann. § 21.200(355)(4)).

A share dividend or other distribution of shares of a corporation must be accompanied by a written notice disclosing the amounts by which the distribution affects stated capital, capital surplus, and earned surplus. Id. § 450.1356 (Mich. Stat. Ann. § 21.200(356)). If such amounts are not determinable at the time of notice, the notice must set forth the approximate effects of the distribution on such accounts and a statement that the amounts are not yet determinable. Id..

\textsuperscript{167} As to when a director is presumed to concur in board action, see id. § 450.1553 (Mich. Stat. Ann. § 21.200(553)).

\textsuperscript{168} Id. § 450.1551(1)(a) (Mich. Stat. Ann. § 21.200(551)(1)(a)). This phraseology leaves open the question of whether directors are liable for an illegal share dividend. See supra note 77.

\textsuperscript{169} Id. § 450.1551(1)(b) (Mich. Stat. Ann. § 21.200(551)(1)(b)). It is not clear from the statute whether directors are liable for an illegal redemption of shares.


\textsuperscript{172} The directors’ liability may be less than the amount unlawfully paid or distributed in the event that the legally recoverable injuries suffered by the corporation’s creditors and shareholders as a
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A shareholder who accepts or receives a dividend or distribution with knowledge of facts indicating it is not authorized by the Act is liable to the corporation for the amount accepted or received.  

A director against whom a claim is successfully asserted for an illegal dividend distribution or purchase is entitled to contribution from the other directors who voted for, or concurred in, such action. Upon payment to the corporation of any amount of an improper dividend or distribution, such a director is entitled to be subrogated to the rights of the corporation against shareholders who received the dividend or distribution in proportion to the amounts received by them. Upon payment to the corporation of any amount of the purchase price of an illegal purchase of shares, such a director is entitled either to have the corporation rescind the purchase and recover for the director’s benefit the amount of the purchase price from any seller who sold such shares with knowledge that such purchase was illegal, or to have the corporation assign to such director such shares and any claim against the seller.


These provisions appear to impose on the groups interested in the amount of corporate financial distributions and the groups involved in result of the illegal action are less than the amount paid. See id. § 450.1551(1) (Mich. Stat. Ann. § 21.200(551)(1)).


175. Id. § 450.1552(2)(a) (Mich. Stat. Ann. § 21.200(552)(2)(a)). This subsection does not refer, as does the one immediately following, to shareholders who have received illegal dividends with knowledge of their illegality. Such limitation, however, is imposed by § 551(3), which defines the shareholders liable to the corporation for illegal dividends in terms of knowledge of their illegality. Id. § 450.1551(3) (Mich. Stat. Ann. § 21.200(551)(3)). See Sullivan & Young, Officers and Directors, 18 Wayne L. Rev. 951, 958 n.50 (1972).

176. Mich. Comp. Laws § 450.1552(2)(b) (Mich. Stat. Ann. § 21.200(552)(2)(b) (Callaghan 1983)). In the event the corporation recovers for the director’s benefit, the director bears the cost of such recovery. Id. Although the language is not entirely clear on the matter, it appears that the subsection intends purchases of shares that may be partially valid to result in shareholder liability only to the extent of the illegal portion of the purchase. Moreover, it is not clear under the language whether the corporation’s recovery is limited to the amount the director has paid to the corporation. Finally, if the director pursues the option of assignment of the corporation’s claim to the director, it is not clear what the source of the corporation’s claim is.

177. It appears that the Michigan Corporation Law provisions will cause a slightly larger loss of revenue for governmental units that tax income than would result from the operation of the Model Act provisions. The Michigan provisions permit the same recycling of surplus on share repurchases permitted under the Model Act, see supra note 83, and thus have the same bias toward share repurchases. But share repurchases may be less expensive to consummate in Michigan, see infra text.
the administration of the provisions costs that are somewhat less than those resulting for such groups from the operation of the pre-1980 Model Act provisions.

Most Michigan corporations will incur essentially\textsuperscript{178} the same costs in determining the appropriate accounting treatment for transactions affecting their shareholders' equity accounts that they would have incurred had they been incorporated in a Model Act state.\textsuperscript{179} Any Michigan corporation writing up assets to reflect current fair market values\textsuperscript{180} and basing its accompanying notes 186–96, than in a Model Act state, and thus more repurchases may occur as a result of the Michigan provisions.


179. A rapid reading of the Michigan provisions may lead one to conclude that the emphasis in the dividend and share repurchase provisions on "surplus," rather than on "earned" or "capital" surplus as under the Model Act, will result in less time being spent by accountants determining for Michigan corporations which surplus account ought to be charged in connection with a transaction. However, the notice required by Michigan Corporation Law § 351(3) in connection with dividends from any source other than earned surplus clearly requires the same degree of accounting effort to segregate transaction effects that is required under the Model Act. MICH. COMP. LAWS § 450.1351(3) (MICH. STAT. ANN. § 21.200(351)(3) (Callaghan 1983)). See also de Capriles & McAniff, supra note 178, at 1265–66 (discussing of a similar New York provision).

180. It appears the Michigan Law Revision Commission thought that unrealized appreciation must be entered on the corporation's books before it could be the source of a dividend or share repurchase. See LAW REVISION REPORT, supra note 135, at 83 ("definitions [of] . . . earned surplus, capital surplus, and total assets . . . clearly permit appraisal write-ups of assets and assign these increases to capital surplus"). Support for this position may be found in a liberal reading of MICH. COMP. LAWS § 450.1110(1) (MICH. STAT. ANN. § 21.200(110)(1) (Callaghan 1983)) (" 'Total Assets' means the total of the properties and rights entered upon the books of a corporation in accordance with generally accepted accounting principles, or the current fair market value of such properties and rights."). However, the sentence following the Law Revision Commission quotation above says "the new law clearly adopts the principle of Randall v. Bailey," 23 N.Y.S.2d 173 (Sup. Ct. 1940), aff'd mem., 262 A.D. 844, 29 N.Y.S.2d 512 (1941), aff'd, 288 N.Y. 280, 43 N.E.2d 43 (1942). LAW REVISION REPORT, supra note 135, at 83. The supreme court opinion in Randall assumes that unrealized appreciation can be the source of a dividend even if it is not entered on the corporation's books. Randall, 23 N.Y.S.2d at 184.

If the Michigan Act can be construed to permit a dividend to be distributed out of unrealized appreciation that is not entered on the corporation's books, it is not clear how the corporation would account for the dividend. One possibility is that the corporation would simply debit capital surplus for the amount of the dividend and show a deficit in capital surplus upon its financial statements. Such treatment may be contrary to the rather vague accounting principle that distributions identified as dividends ought to be charged to retained earnings. See FASB ACCOUNTING STANDARDS, JUNE 1973, supra note 84, at 24 (Accounting Research Bull. No. 43, ch. 7B, ¶ 10, issued June 1953) (concerning the appropriate accounting for small stock dividends). It is not clear whether the deviation is significant enough to require reviewing accountants to give a qualified or adverse opinion on the corporation's financial statements. It is also not clear whether the SEC would object to this presentation, assuming that the corporation has no earned surplus and that the notes to the financial statements adequately explain the transaction. Cf. L. RAPPAPORT, supra note 103, at 18.32–33.
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financial statements on such values\textsuperscript{181} can expect to receive an adverse opinion from any certified public accountant asked to review its financial statements\textsuperscript{182} and to incur increased future accounting costs\textsuperscript{183} related to the written-up assets.\textsuperscript{184}

\textsuperscript{181} It is possible that a corporation could write up assets on its books, but would prepare its financial statements on the basis of generally accepted accounting principles. It would presumably account for any dividends paid out of unrealized appreciation in the manner described \textit{supra} note 180. If such accounting did not result in reviewing accountants rendering a qualified opinion, possibly the book write-up and financial statements based on generally accepted principles would also avoid such an opinion. It is not clear, however, that preparing statements in this fashion would be in accord with generally accepted accounting principles. \textit{Compare} FASB \textit{Accounting Standards}, June 1973, \textit{supra} note 84, at 127 (APB Opinion No. 6, § 17, issued Oct. 1965) ("Whenever appreciation has been \textit{recorded on the books}, income should be charged with depreciation computed on the written up amounts.") (emphasis added) \textit{with} its predecessor, FASB \textit{Accounting Standards}, June 1973, \textit{supra} note 84, at 32 (Accounting Research Bull. No. 43, ch. 9B, § 2, issued June 1953) which states, immediately after the sentence just quoted:

\begin{quote}
A company should not at the same time claim larger property valuations \textit{in its statement of assets} and provide for the amortization of only smaller amounts in its statement of income. When a company has made representations as to an increased valuation of plant, depreciation accounting and periodic income determination thereafter should be based on such higher amounts.
\end{quote}

\textit{Id.} (emphasis added).

\textsuperscript{182} The rules of ethics of the American Institute of Certified Public Accountants make it generally unethical for a member to express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the [Accounting Principles Board and by the Financial Accounting Standards Board] which has a material effect on the statements taken as a whole. \textit{American Inst. of Certified Public Accountants, Professional Standards} vol. B, 4581–82, Code of Professional Ethics Rule 203 (1983). The rules contain an exception where the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. \textit{Id.}

The Accounting Principles Board has stated that "property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity." FASB \textit{Accounting Standards}, June 1973, \textit{supra} note 84, at 127 (APB Opinion No. 6, § 17, issued Oct. 1965). \textit{See also Financial Accounting Standards Bd., Accounting Standards, Original Pronouncements, July 1973–June 1, 1983, at 1138 (1983) (Statement of Financial Accounting Standards No. 12, § 29, issued Dec. 1975) [hereinafter cited as FASB \textit{Accounting Standards}, 1973–1983], in which the Board excluded from its consideration market value as the only determinant for the carrying value of certain marketable securities and adopted as a general rule that marketable securities should be carried at the lower of cost or market, determined as of the balance sheet date. Note that these positions are not changed by FASB \textit{Accounting Standards}, 1973–1983, \textit{supra}, at 1400-01 (Statement of Financial Accounting Standards No. 33, § 29–38, issued Sept. 1979), which requires large enterprises to present as supplementary information in annual reports current cost information on inventory and property, plant, and equipment. That statement made no change in the primary financial statements produced by those enterprises.

It thus appears that barring unusual circumstances, a corporation writing up assets for appreciation in value must receive an adverse opinion from any reviewing certified public accountant (i.e., that the statements are not fairly presented in conformity with generally accepted accounting principles). \textit{See} Fiflis, \textit{Current Problems of Accountants' Responsibilities to Third Parties}, 28 \textit{Vand. L. Rev.} 31, 42 (1975).

\textsuperscript{183} When unrealized appreciation has been recorded on the corporation's books and used in the preparation of its financial statements, the corporation must thereafter determine income using the
Michigan corporations wishing to obtain a large or long-term loan will incur somewhat greater costs in arranging such loans than they would have incurred had they been incorporated in a Model Act state.\(^{185}\)

appreciated value as the accounting cost for the asset. Thus, for example, future depreciation deductions on an asset subject to depreciation would be based on the appreciated amount. See *FASB Accounting Standards*, June 1973, supra note 84, at 127 (APB Opinion No. 6, ¶ 17, issued Oct. 1965). But some controversy exists as to whether the unrealized appreciation is ultimately transferred to earned surplus, either gradually as depreciation is taken on the appreciated asset, or in a lump sum when the asset is retired. See D. Herwitz, supra note 104, at 339 ed. note.

Additional accounting costs are likely to be incurred in the event the corporation desires to make a public offering of its securities. The SEC is firmly opposed to the writing-up of assets above their cost for purposes of preparation of prospectuses for such offerings. See L. Rappaport, supra note 103, at 3.27. Thus, a corporation that has recognized unrealized appreciation presumably will be forced to restate its accounts for such purpose.

\(^{184}\) There are likely to be costs other than accounting costs that result from recognition of unrealized appreciation and from the receipt of adverse opinions on the corporation’s financial statements. If the corporation has shares listed in the New York Stock Exchange, preparation of annual financial statements not in accord with generally accepted accounting principles appears to be a violation of the Exchange’s listing agreement which could lead to delisting. See *New York Stock Exchange, Company Manual* B-44 & A-294 (1968). If the corporation has securities registered with the SEC, financial statements based on current value (and thus not prepared in accordance with generally accepted accounting principles) filed with the Commission will be presumed to be misleading, despite footnote or other disclosures. See 17 C.F.R. § 210.4-01(a)(1) (1983). Such a finding may ultimately lead the Commission to suspend trading in the security or to impose other sanctions on the corporation. See H. Bloomental & S. Wing, *Securities Law* 3-67 to -74 (1973). Credit-rating services will almost certainly call the accountants’ opinion to the attention of prospective creditors and the corporation may thereafter encounter more difficulty in securing credit. Long-term creditors asking for such financial statements may refuse to grant credit or may attach more stringent conditions on any loan.

\(^{185}\) The issue is whether long-term or large creditors dealing with Michigan corporations will impose protective covenants either more stringently or more frequently than they would have imposed had the corporate debtors been incorporated in a Model Act state. It seems doubtful that creditors will impose more stringent covenants on Michigan corporations. The survey of listed corporations earlier noted that most covenants limit distributions to shareholders to earnings since the date of the loan and possibly by means of a working capital test. See Kummert, supra note 10, at 374 n.63. Such covenants, which are designed to protect creditors against the most permissive financial provisions, operate to protect creditors of Michigan corporations just as effectively as they protect creditors of Model Act corporations. It is possible, however, that creditors will impose protective covenants more often in Michigan. They may perceive certain features in the Michigan Act (e.g., relatively free use of capital surplus for distributions; clear authority to use unrealized appreciation) as being more permissive than the analogous Model Act provisions. But even if creditors react in this fashion, costs should not be significantly increased for Michigan corporations because it appears that such covenants already turn up in many loan agreements. *See id.*

Preferred shareholders receive somewhat less protection under the Michigan Act than under the Model Act. The Model Act contains a number of provisions that cause the corporations to retain net assets in an amount at least equal to the liquidation preference of any outstanding preferred shares. *See, e.g.*, *Model Business Corp. Code* § 46 (1979). Under the Michigan Act, such protection exists only to the extent that the liquidation preference of the preferred shares is less than the stated capital of the outstanding shares in the corporation. That fact may lead counsel for new issues of preferred shares to insert covenants protecting the shares’ liquidation preference. Such covenants, however, are not strong protection for the interest of the preferred shareholders. Moreover, the earlier survey of preferred covenants (showing few protections of any type), *see Kummert, supra note 10, at 374 n.63.*
Michigan corporations considering a proposed financial distribution to shareholders will generally bear less cost in determining whether the distribution can be legally made than they would have incurred had they been incorporated in a Model Act state. Consider the costs involved for a small Michigan corporation in consummating an installment repurchase of shares. Counsel for such a corporation must resolve most of the following questions: (a) how the insolvency limitation applies to installment repurchases of shares; (b) whether capital surplus may be re-

seems to indicate that counsel for the shareholders are not aggressive in seeking protections in any event.

Trade creditors' costs in granting credit should not be any greater in extending credit to Michigan corporations than to Model Act corporations. See supra note 88.


A proposed dividend appears to raise only the following issues for counsel under the Michigan Act: (1) if current valuation of assets is elected by the corporation, what approach to determining current value should be used; (2) whether transactions affecting the corporation's surplus accounts have been appropriately matched to a surplus account (so that the corporation can determine whether notice is required under Mich. Comp. Laws § 450.1351(3) (Mich. Stat. Ann. § 21.200(351)(3) (Callaghan 1983)); and (3) what constitutes reasonable care by the directors in effecting the dividend.

The following issues that counsel advising a Model Act corporation on such a transaction might face are resolved or irrelevant under the Michigan Act: (a) whether application of the insolvency test is affected by use of a negotiable instrument or a security device (irrelevant since the insolvency limitation is applied only at the outset, see infra note 189); (b) how the surplus test is applied to installment repurchases of shares (resolved, outset test, by Mich. Comp. Laws § 450.1367 (Mich. Stat. Ann. § 21.200(367) (Callaghan 1983)); see Law Revision Report, supra note 135, at 91; (c) how the corporation's surplus is affected if the reacquired shares are cancelled (resolved, capital surplus is created, under Mich. Comp. Laws §§ 450.1372(2), 1381(1)(c) (Mich. Stat. Ann. §§ 21.200(372)(2), (381)(1)(c) (Callaghan 1983)); (d) what valuation standard is to be used in valuing a corporation's assets, and thus in determining its surplus (resolved, current fair market value is acceptable, under id. § 450.1107(1) (Mich. Stat. Ann. § 21.200(107)(1))); and (e) what type of surplus results from the corporation's recognition of unrealized appreciation (resolved, capital surplus, id. §§ 450.1106(1), 1107(1) (Mich. Stat. Ann. §§ 21.200(106)(1), 107(1)); see Law Revision Report, supra note 135, at 7-8.

If generally accepted accounting principles are used by the corporation to determine the value of its assets, the Michigan provisions reduce the relevance in connection with share repurchases of whether transactions affecting the corporation's surplus accounts have been appropriately matched to a surplus account. Michigan attaches no special procedures to the use of capital surplus on share repurchases. Thus, a repurchase can be effected with no concern as to whether the respective balances in earned and capital surplus are correct (assuming total surplus is correct). However, the respective balances still have relevance in connection with dividend distributions because of the notice requirement in Michigan Corporation Laws § 351(3) on dividends from sources other than earned surplus. Mich. Comp. Laws § 450.1351(3) (Mich. Stat. Ann. § 21.200(351)(3) (Callaghan 1983)). It thus seems likely that careful counsel will continuously monitor transactions affecting the respective balances.


The answer can be obtained from a careful reading of the statutory provisions. The insolvency limitation prohibits purchases of a corporation's own shares when the corporation is insolvent...
duced in connection with a repurchase even though the corporation also has earned surplus;\(^{(190)}\) (c) if current fair market valuation is used to determine the value of the corporation’s assets, and thus its surplus, what approach to determining current value is to be used;\(^{(191)}\) (d) how these questions are affected if the acquiring corporation has subsidiaries,\(^{(192)}\) or if the

or when the purchase would render the corporation insolvent. Id. § 450.1365(2) (Mich. Stat. Ann § 21.200(365)(2)). Under § 367, a corporation which has purchased its own shares out of surplus may defer payment for the shares as agreed by it and the selling shareholder. Id. § 450.1367 (Mich. Stat. Ann. § 21.200(367)). This statement implies that a purchase occurs at the time the shares were reacquired. It would therefore follow that under § 365 the insolvency limitation applies only at such time (and not to later payments). Id. § 450.1365 (Mich. Stat. Ann. § 21.200(365)). Such conclusion is buttressed by the next sentence in § 367 which states that the deferred payment obligation “constitutes an ordinary debt of the corporation and the validity of any payment upon the debt so created is not affected by the absence of surplus at the time of payment.” Id. § 450.1367 (Mich. Stat. Ann. § 21.200(367)) (emphasis added).


Under subsection (6), if a purchase, otherwise lawful, is made out of surplus, any deferred payment obligation may be treated as an ordinary liability and surplus may be charged immediately. The lawfulness of payment of such an obligation thereafter does not depend upon the fortunes of the corporation between the time of purchase, i.e., when the shares were reacquired, and the time of payment. So long as the corporation is solvent at the time of payment, the state of the net worth accounts is irrelevant. The effect of insolvency upon the lawfulness of such a payment is considered by the Commission to be the same as in the case of any other debt of the corporation, subject to the application of settled equitable principles, and is not determined by this Act.

N.J. Stat. Ann § 14A:7-16(6) comment (West 1969). Earlier in its discussion, the commission announced its desire to return the law in New Jersey to the view expressed in Wolff v. Heidritter Lumber Co., 112 N.J. Eq. 34, 163 A. 140 (1932), which also supports the conclusion stated above.

190. The Michigan Act does not specify that shares repurchased (or, for that matter, dividends) out of surplus shall first be deducted from any earned surplus the corporation has. Moreover, the Act does not require notice to be provided to shareholders when shares are repurchased out of capital surplus. Such notice is required on dividends paid out of capital surplus, see Mich. Comp. Laws § 450.1351(3) (Mich. Stat. Ann. § 21.200(351)(3) (Callaghan 1983)), and is thought to encourage exhaustion of earned surplus before dividends are charged to capital surplus. See de Capriles & McAniff, supra note 178, at 1259. The requirement of notice on dividend payments out of capital surplus and the lack thereof on share repurchases from the same source will encourage corporations to charge share repurchases to capital surplus whenever possible. Such accounting may provoke a reaction from the SEC and from some accountants. See L. Rappaport, supra note 103, at 18.32–33.

191. See Hackney, supra note 106, at 819–21 (discussing the choices).

192. A Michigan corporation choosing to determine its "total assets" in accordance with generally accepted accounting principles must report its investment in a subsidiary under the equity accounting method in any case in which the corporation has significant influence over the operating and financial policies of the investor. FASB Accounting Standards, June 1973, supra note 84, at 262 (APB Opinion No. 18, ¶ 17, issued March 1971). Under that method, the investor’s share of the investee’s income will be included in the investor’s earned surplus. Id. at 260. It is not clear whether the investor’s share of the investee’s income is meant to be included within earned surplus for purposes of Mich. Comp. Laws § 450.1107(1) (Mich. Stat. Ann. § 21.200(107)(1) (Callaghan 1983)). However, such amount would in any event be "capital surplus." See id. §§ 450.1106(1), .1108(a), .1109(4) (Mich. Stat. Ann. § 21.200(106)(1), (108)(a), (109)(4)). Given the relative freedom under
acquiring corporation is a subsidiary corporation acquiring its parent's stock;\(^\text{193}\) and (e) what constitutes reasonable care by directors in effecting such a transaction.\(^\text{194}\) If the corporation elects to use current value as the valuation standard for its assets, it probably will incur additional costs for studies by appraisers\(^\text{195}\) to determine current values. The corporation must also incur the cost of an analysis of its short-term cash flows in order to determine the effect of the proposed repurchase on its ability to pay its debts as they become due in the usual course of its business.\(^\text{196}\) Finally,

- the Act to use capital surplus for repurchases, see supra note 190, the issue therefore is mainly related to notice problems on future dividend payments. \(\text{Id.}\)

  A Michigan corporation choosing to determine its "total assets" by determining the current fair market value of its properties would recognize any excess of the fair market value of its investment over its carrying value as capital surplus. See supra text accompanying note 152.

  \(^\text{193}\) The issues appear to be the same as those discussed in Kummert, Financial Provisions (pt. 3), supra note 77, at 372 n.727.


  A director or an officer shall discharge the duties of his position in good faith and with that degree of diligence, care and skill which an ordinarily prudent man would exercise under similar circumstances in a like position. In discharging his duties, a director or an officer, when acting in good faith, may rely upon the opinion of counsel for the corporation, upon the report of an independent appraiser selected with reasonable care by the board, or upon financial statements of the corporation represented to him to be correct by the president or the officer of the corporation having charge of its books of account, or stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of the corporation.

  Id. § 450.1541(1) (Mich. Stat. Ann. § 21.200(541)(1)). The questions counsel generally must address under such provisions are virtually the same as those noted under the Model Act provisions, see supra note 111. In the event the corporation chooses to value its assets in accordance with generally accepted accounting principles (an acceptable standard under § 110), counsel will have to reconcile the language in the last two clauses of § 541 with that in § 110. Id. §§ 450.1110, 1541 (Mich. Stat. Ann. §§ 21.200(110), (541)).

  A recent case, Libco Corp. v. Leigh (In re Reliable Mfg. Corp.), 703 F.2d 996 (7th Cir. 1983), suggests another issue that may arise in balance sheet surplus jurisdictions. That case involved a purchase by Libco Corp. of all of the stock of the two individual shareholders of Reliable Manufacturing Corp. where Reliable was caused to execute a security agreement and guarantee of the purchasing company's obligation. Reliable later argued that the guarantee was unenforceable as a repurchase of its own shares which would impair its capital under Del. Code Ann. tit. 8, § 160 (1983). Reliable, 703 F.2d at 1000–03. The court concluded that § 160 did not apply, in part because "the policies underlying Section 160 are not implicated in this case," id. at 1002, and in part because the corporation's capital was not at the time of the execution of the guarantee, nor by virtue of such execution, impaired, id. at 1002–03. The court never discussed whether the execution of the guarantee constituted a dividend—i.e., incurring a debt only for the benefit of a shareholder—nor whether the effects of such a dividend ought to be measured at the time of entry of the guarantee.


  \(^\text{196}\) That is, whether the repurchase can be made without violating the insolvency limitation. See id. §§ 450.1365(2)(b), 1107(3) (Mich. Stat. Ann. §§ 21.200(365)(2)(b), (107)(3)).

  On the determination of insolvency, see the helpful comment of the ABA Committee on Corporate
the corporation will bear the cost of directors’ time devoted to the study of lawyers’ opinions, appraisals, data on cash flows, and the possibility of directors’ liability if the distribution is subsequently found to have been illegal. Such costs should be less for a Michigan corporation than they would have been for a Model Act corporation.

General, unsecured creditors of Michigan corporations that have made installment repurchases of shares and that have become insolvent before the repurchase obligation is satisfied are likely to suffer greater losses under these provisions than they would have suffered had the corporations been incorporated under the Model Act. Under the Model Act, the obligation to the selling shareholder is subordinated to obligations to general, unsecured creditors in the event of later insolvency. But under the Michigan Act, the obligation to the selling shareholder is accorded parity with obligations to general, unsecured creditors if surplus at the time of purchase equalled the purchase price. If such status is honored in bankruptcy, and if, as is typical, available assets in such event are less than corporate indebtedness to general, unsecured creditors, payments to the selling shareholder by virtue of the operation of the Michigan provision serve to increase the losses suffered by general, unsecured creditors.

Because the costs involved in determining the validity of a proposed distribution and the risks connected with such distribution are less than they would have been had the corporation been incorporated in a Model Act state, costs for parties in the corporate solution related to abandoned distributions should therefore generally be less for Michigan corporations than for Model Act corporations. Similarly, parties connected with disputes over the impact of the Michigan provisions are likely to incur less cost in settling or litigating a dispute than they would have incurred had the corporation involved been a Model Act corporation. Because of the clear availability of unrealized appreciation, common shareholders of Michigan corporations with more than one class of shares may have fewer

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Laws, infra at note 318, and Murphy, supra note 112, 855–71. Murphy raises, but does not resolve, a question counsel may have to address in providing instruction to persons gathering cash-flow information: how long must a corporation be solvent after the distribution to escape operation of the statute?


199. The incurring of such obligation may be a fraudulent conveyance under the federal bankruptcy statute or state fraudulent conveyance law. See infra Part III B1. If it is such, the trustee in bankruptcy, or creditors of the corporation, can have the obligation avoided.

200. See Kummert, supra note 10, at 375 n.67.

201. See supra note 114. Note that under the Michigan Act the selling shareholder apparently is not exposed to subordination of his or her claim in the event the corporation becomes insolvent after (and not as a result of) the repurchase. See supra note 189.
Restrictions on Corporate Distributions

occasions to seek a reduction of stated capital than common shareholders of Model Act corporations. Thus, the cost such shareholders may bear to gain approval of such reductions should be less for shareholders of Michigan corporations than for Model Act corporations. Finally, current or prospective shareholders of publicly held corporations incorporated in Michigan attempting to gauge prospects for share prices from changes in the corporation’s dividend rate are likely to bear the same investment losses or additional information costs they would have borne had the corporations been incorporated in a Model Act state.


These costs, although lower than the costs arising from the operation of the Model Act provisions, produce almost precisely the same benefits that groups interested in the amount of corporate financial distributions and groups involved in the administration of the legal limitations received from the operation of the Model Act provisions. Such costs appear to far exceed the benefits.

In view of the relative imbalance of costs and benefits resulting from the operation of balance sheet surplus provisions, legislatures in states with provisions based on that concept should consider alternative provisions with more favorable cost-benefit comparisons. The next section studies three alternatives, all of which are based on concepts other than legal capital, and all of which provide more favorable cost-benefit comparisons.

202. The only difference in benefits received appears to be that professionals as a class will receive somewhat smaller benefits under the balance sheet surplus provisions than under the Model Act provisions. Lawyers as a group should receive less work as a result of the operation of the balance sheet surplus provisions than they would receive as a result of the operation of the Model Act provisions. Appraisers should receive more work as a result of the balance sheet surplus provisions than they would receive as a result of the Model Act provisions.


2. Statutory Systems Not Based on Legal Capital

a. California Corporations Code

i. Summary of the California Provisions

California imposes a series of restrictions on "distributions" by a corporation to its shareholders.\(^{204}\) Distributions are defined\(^{205}\) as transfers of cash or property\(^{206}\) by a corporation to its shareholders without consideration, whether by way of dividend,\(^{207}\) purchase, or redemption of its

\(^{204}\) Alaska is considering adopting distribution provisions similar to those in California. See Alaska H.B. 343, §§ 10.06.358, .360, 13th Leg., 1st Sess. (1983) (currently in the Alaska House Labor and Commerce Committee); ALASKA H. & S.J. JOURNAL SUPP. No. 11, at 64–75 (Apr. 8, 1983) (commentary on proposed Alaska Corporations Code).


\(^{206}\) California does not (as do the Amended Model Act, see infra note 278, and Minnesota Act, see infra note 335) specifically include as a form of distribution the incurrence of debt by the corporation. Presumably a distribution of the corporation's long-term debt to its shareholders as a dividend is, for purposes of the statute, a "distribution" of the corporation's property, the effect of which is measured on the date of declaration by the corporation's board of directors. See infra text accompanying note 229.

\(^{207}\) Section 166 of the California Corporations Code excepts from its definition "a dividend in shares of the corporation." CAL. CORP. CODE § 166 (West 1977 & Supp. 1983). This exception was apparently inserted lest a court be misled into believing that such a dividend represented a transfer of property by the corporation to its shareholders. See 2 H. MARSH, CALIFORNIA CORPORATION LAW 130 (2d ed. 1983) (Mr. Marsh was the principal author of the California General Corporation Law taking effect January, 1977. See 1 id. 9.). By analogy, shares issued in connection with a stock split also should not be considered a "distribution." See 1 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS 8-95 (R. Clark 4th ed. 1981). Also, by analogy, it would seem that a voluntary exchange of shares in the corporation—a recapitalization—is not a distribution. See CAL. CORP. CODE § 409(a)(2) (West 1977 & Supp. 1983) (equating such transactions with share dividends for purposes of consideration required).

The term "share dividend" is not defined in the statute. Such dividends are distinguished in id. § 188 (West 1977) from a "stock split," which is defined as a pro rata division, other than by share dividend, of all the outstanding shares of a class into a greater number of shares of the same class by an amendment to the articles of incorporation stating the effect on the shares. The procedures in the statute for share dividends requiring an increase in the number of authorized shares are different from those for a stock split requiring a similar increase. See Ackerman & Sterrett, California’s New Approach to Dividends and Reacquisitions of Shares, 23 U.C.L.A. L. REV. 1052, 1055 (1976). Accounting for share dividends and stock splits is left to accountants to be determined under generally accepted accounting principles. See 2 H. MARSH, supra, at 190.

Accounting principles for stock dividends and split-ups are set forth in FASB ACCOUNTING STANDARDS, JUNE 1973, supra note 84, at 22–26 (Accounting Research Bull. No. 43, ch. 7B, issued June 1953). That bulletin distinguishes between the two primarily on the basis of the desire of management to effect a material reduction in the market price per share by means of a significant increase in outstanding shares. See id. at 23–24, §§ B1, B2, B13. If such intent exists, the issuance of shares is a stock split and no transfer from earned surplus to capital surplus or stated capital is required other "than to the extent occasioned by legal requirements." See id. at 25, § B15. California has no such legal requirements, see CAL. CORP. CODE § 409(a)(2) (West 1977 & Supp. 1983), and thus no entries would be made. If the intent to effect a material reduction in price does not exist, the issuance is a stock dividend for accounting purposes and a transfer equal to the fair market value of the shares must be made from earned surplus to stated capital and capital surplus. See FASB ACCOUNTING STAN-
Restrictions on Corporate Distributions

shares, or otherwise.\textsuperscript{208} The term also includes such transfers to the shareholders of a corporation by its subsidiary.\textsuperscript{209}

A California\textsuperscript{210} corporation\textsuperscript{211} with a single class of shares may not make a proposed distribution to its shareholders unless it meets one of two alternative tests, and meets an insolvency limitation, with respect to the distribution.\textsuperscript{212} A proposed distribution may not be made by a corporation unless \textit{either}: (a) the corporation, immediately prior to the proposed distribution, has retained earnings at least equal to the amount of the distribution;\textsuperscript{213} or (b) the corporation, after giving effect to the pro-

\textsuperscript{208} The words "or otherwise" apparently were included in the statute to ensure regulation of all transactions whereby the corporation transfers assets to shareholders and does not receive in return an equivalent consideration in the form of assets equally available for the prior claims of creditors or preferred shareholders. Thus, a purported salary paid to a shareholder who had rendered no services to the corporation would be a distribution, as would a transfer of the corporation's assets to its shareholders pursuant to an informal liquidation. See 2 H. Marsh, supra note 207, at 129-30.

\textsuperscript{209} CAL. CORP. CODE \S 189(a) (West 1977) defines a subsidiary for this purpose as a corporation in which shares constituting more than 50\% of the voting power of that corporation are owned directly, or indirectly through one or more subsidiaries, by another corporation. "Voting power" is defined in id. \S 194.5 as the power to vote for the election of directors at the time any determination of voting power is made and does not include contingent voting rights.

\textsuperscript{210} Section 2115 of the California Corporations Code applies its rules on distributions to corporations incorporated under the laws of other states which do a significant part of their business in California and the shares of which are owned in substantial part by persons having addresses in the state. CAL. CORP. CODE \S 2115 (West 1977 \& Supp. 1983). A number of issues raised by this provision in connection with planning distributions are discussed in Halloran \& Hammer, \textit{Section 2115 of the New California General Corporation Law—the Application of California Corporation Law to Foreign Corporations}, 23 U.C.L.A. L. Rev. 1282, 1307-12 (1976). A number of constitutional issues raised by the provision are discussed in Comment, \textit{California's New General Corporation Law: Quasi-Foreign Corporations}, 7 Pac. L.J. 673, 693-98 (1976).

\textsuperscript{211} Id. \S 500(a) (West 1977 \& Supp. 1983).

As discussed \textit{infra} text accompanying notes 225 \& 228, a corporation's retained earnings are deter-
posed distribution, would have both (1) total assets (excluding goodwill, capitalized research and development expenses, and deferred charges) at least equal to \( \frac{1}{4} \) times its liabilities\(^{214}\) (excluding deferred taxes, deferred income, and other deferred credits), and (2) current assets at least equal to its current liabilities.\(^{215}\) A corporation meeting either the retained earnings test or both of the remaining assets tests with respect to a proposed distribution may not make the distribution\(^{216}\) if it is, or as a result of the distribution would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature.\(^{217}\)
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California corporations with an outstanding class or series of shares senior to shares of another class or series with respect to either distribution of assets in liquidation or payment of dividends must satisfy additional limitations before distributions may be made to holders of the junior class or series of shares. Such corporations may not make a distribution to holders of shares of any class or series junior to outstanding shares of any other class or series with respect to distribution of assets on liquidation, if, after giving effect to the proposed distribution, the excess of its assets (excluding goodwill, capitalized research and development expenses, and deferred charges) over its liabilities (excluding deferred taxes, deferred income, and other deferred credits) would be less than the liquidation preference of all shares having a preference on liquidation over the class or series to which the distribution is to be made.218

Further, such corporations may not make a distribution to holders of shares junior to outstanding shares of any other class or series with respect to payment of dividends unless the corporation’s retained earnings immediately prior thereto at least equal the amount of the proposed distribution plus the aggregate amount of cumulative dividends in arrears on all shares having a preference with respect to payment of dividends over the class or series of shares to which the distribution is to be made.219

These tests and limitations do not apply to a purchase or redemption of shares from a deceased shareholder to the extent that such reacquisition is made from any excess of proceeds received by the corporation from in-

Id. at 151. But see Ackerman & Sterrett, supra note 207, at 1059 (arguing the former definition should continue to be applied); H. BALLANTINE & G. STERLING, supra note 207, at 8-14 (arguing that the definition of “adequately provided for” in California’s corporate dissolution provisions, CAL. CORP. CODE § 2005 (West 1977), ought to be applied to § 501).


CAL. CORP. CODE § 1306 (West 1977) provides that to the extent the provisions of its distributions chapter prevent the payment to any holders of dissenting shares (this term is defined in id. § 1300(b) (West 1977 & Supp. 1983)) of their fair market value, they shall become creditors of the corporation for that amount plus interest at the legal rate on judgments until the date of payment. Such debt is to be paid when permissible under the California distribution provisions and is subordinate to all other creditors in any liquidation proceeding. Thus, contrary to the former California law (see former CAL. CORP. CODE § 1706 (repealed 1975), which made an exception to the restrictions on repurchases of shares for repurchases from dissenters), the distribution provisions now apply to corporate purchases of dissenting shares.
surance on the life of the shareholder over premiums paid by the corporation for such insurance and where such reacquisition executes an agreement between the corporation and the deceased shareholder to reacquire the shares on the death of the shareholder. Further, none of California’s provisions regulating distributions apply to any proceeding for voluntary or involuntary dissolution. Finally, notwithstanding the provisions set forth above, a negotiable instrument issued by a corporation for the purchase or redemption of shares is enforceable by a holder in due course without notice that it was issued for such purpose.

California corporations distributing dividends that are not charged to retained earnings must provide a notice to shareholders identifying the dividend as having been made from a source other than retained earnings and stating its accounting treatment.

California provides that all references to financial statements and to assets, liabilities, earnings, retained earnings, and similar accounting items of a corporation mean such financial statements or items prepared or determined in conformity with generally accepted accounting principles then applicable, fairly presenting in conformity with such principles the matters they purport to present, subject to any specific accounting treatment required by a section of the law. California further provides that

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220. Cal. Corp. Code § 503.1 (West 1977 & Supp. 1983). This exception was enacted to prevent creditors from acquiring a “windfall” (i.e., the excess of the proceeds over the premiums paid) thought to exist if, despite the existence of such an excess, the rules in id. §§ 500–503 prohibited the purchase or redemption of the shares. See 2 H. Marsh, supra note 207, at 157. Marsh points out that even though such distributions are thus freed of the insolvency limitation in § 501, the provisions of the California (Uniform) Fraudulent Conveyance Act still apply and may prohibit the purchase or redemption in the event of financial difficulty. Id.


223. All forms of distribution other than dividends are free of this requirement. See id. § 507 (West 1977). Marsh states that repurchases of shares, the most common non-dividend form of distribution, will normally be reflected in the corporation’s financial statements. 2 H. Marsh, supra note 207, at 190. California requires that financial statements be distributed to shareholders of most corporations. See Cal. Corp. Code § 1501 (West 1977 & Supp. 1983).

224. Cal. Corp. Code § 507 (West 1977). The notice must either accompany the dividend or be given within three months after the end of the fiscal year in which the dividend is paid.

225. Id. § 114 (West 1977 & Supp. 1983). Marsh states that the drafting committees decided to use generally accepted accounting principles to define accounting items in the statute in order to avoid the need for corporations to maintain a special set of accounting records for use in distribution decisions. 2 H. Marsh, supra note 207, at 132–33.

The California statute specifies required accounting treatment in the following sections: (a) sections 500(b)(1) (the first part of the alternate remaining assets test, see supra text accompanying note
unless otherwise stated, all references in its law to financial statements for

214) and 502 (the limitation for corporations that have shares with a liquidation preference outstanding, see supra text accompanying note 218) provide that in determining the corporation’s assets, goodwill, capitalized research and development expenses, and deferred charges are excluded; (b) the same sections provide that in determining the corporation’s liabilities, deferred taxes, deferred income, and other deferred credits are excluded; (c) section 500 (the retained earnings test, and both remaining assets tests) provides that in determining the amount of the assets of the corporation, profits derived from an exchange of assets are excluded unless the assets received are currently realizable in cash; (d) section 500 also provides that in determining a corporation’s current assets, the corporation may include net amounts which the board of directors has determined in good faith may reasonably be expected to be received from customers during the 12-month period used in calculating current liabilities pursuant to existing contractual relationships obligating such customers to make fixed or periodic payments during the term of the contract, or in the case of public utilities, pursuant to service connections with customers, after in each case giving effect to future costs not then included in current liabilities but reasonably expected to be incurred by the corporation in performing such contracts or providing service to utility customers; (e) sections 500 and 503 (the limitation for corporations that have shares with a dividend preference outstanding) provide that for purposes of the application of the respective sections to a distribution of cash or property by a corporation in partial or complete payment of an obligation incurred in a repurchase of shares, the corporation’s retained earnings shall be increased by the lesser of (1) any deduction from retained earnings made when the obligation was incurred, or (2) the unpaid principal of the obligation immediately prior to the distribution; and (f) sections 500 and 502 provide that for purposes of the application of the respective sections to a distribution of cash or property by a corporation in partial or complete payment of an obligation incurred in a repurchase of shares, the amount of the corporation’s liabilities shall be reduced by the lesser of (1) any addition to its liabilities made when the obligation was incurred, or (2) the principal balance of the obligation remaining unpaid after the distribution. CAL. CODE §§ 500–503 (West 1977 & Supp. 1983).

The assets specified in id. §§ 500(b)(1) and 502 are excluded because “they are of no value to creditors if there should have to be a liquidation of the corporation.” 2 H. MARSH, supra note 207, at 138. The liabilities specified in the same sections are excluded “because they do not represent any obligation of the corporation actually to pay money to anyone at any time.” Id. Profits derived from an exchange of assets are excluded apparently because of their resemblance to recognition of unrealized appreciation. Id. at 141. (It is unclear whether such exclusion applies to both the retained earnings test and the remaining assets tests. Marsh interprets the exclusion as applying only to the latter. Id. at 140. But in H. BALLANTINE & STERLING, supra note 207, at 8-13, it is suggested that the exclusion may also apply to the retained earnings test.) Profits to be derived in the next 12 months as a result of existing contracts or service connections may be included as a current asset “to deal realistically with certain types of corporations [e.g., one renting residential property] that may have accrued liabilities in substantial amounts, which are reasonably expected to be discharged out of payments from customers under contracts.” Id. at 8-12. The calculations specified for the retained earnings and liabilities of a corporation making payments on an installment repurchase of shares are made to reverse accounting entries which may have been made at the time the promissory note was issued (which otherwise would have resulted in a reduction of retained earnings and an increase in liabilities). Such action was thought to be necessary to avoid “any duplication of the amount of retained earnings or net worth required to satisfy those tests [those stated in §§ 500–503].” 2 H. MARSH, supra note 207, at 136.

Present § 500, as originally enacted, stated that in determining the amount of the assets of a corporation no appreciation in value should in any event be included, except with respect to readily marketable securities. See Act of Sept. 12, 1975, ch. 682, sec. 7, § 500(b), 1975 Cal. Stat. 1514, 1555. Such provision was deleted by a 1977 amendment, Act of July 7, 1977, § 5-7, 1977 Cal. Stat. 1041, 1054, because “generally accepted accounting principles do not in any event permit the write-up of the value of assets on the basis of appraised values, and it was thought that the exception relating to marketable securities might be too broad.” 2 H. MARSH, supra note 207, at 140–40.1.
a corporation mean, in the case of a corporation with subsidiaries, consolidated statements of the corporation and such of its subsidiaries as are required to be included in such statements under generally accepted accounting principles then applicable. References to accounting items for such corporations mean such items determined on a consolidated basis in accordance with such consolidated financial statements.226

The amount of any distribution payable in property is deemed to be the value at which the property is carried on the corporation’s financial statements in accordance with generally accepted accounting principles.227

The time of any distribution by way of dividend is the date of its declaration by the corporation’s board of directors.228 The time of any distribution by purchase or redemption of shares is generally the date cash or property is transferred by the corporation, whether or not pursuant to an earlier contract.229 However, where a negotiable debt security230 is issued by the corporation in exchange for shares, the time of such distribution is the date when the corporation acquires the shares in such exchange.231

When a corporation acquires232 its own shares, such shares generally are restored to the status of authorized but unissued shares.233 If, however, the corporation’s articles of incorporation prohibit the reissuance of acquired shares, the acquisition causes the authorized number of shares of the class or series, if any, to which such shares belonged to be reduced by the number of shares acquired. The corporation’s articles of incorporation must then be amended to reflect the reduction in authorized shares.234

226. Cal. Corp Code § 114 (West 1977 & Supp. 1983). These provisions also mean that a subsidiary corporation, without subsidiaries of its own, must determine its ability to make distributions to its shareholders on the basis of its own financial statements.

227. Id. § 500 (West 1977).

228. Id. § 166.

229. Id. The section also states that a sinking fund payment in cash or property is deemed transferred for purposes of the section at the time it is delivered to a trustee for the holders of preferred shares to be used for the redemption of such shares or physically segregated by the corporation in trust for that purpose.

230. Section 166, id., incorporates by reference the definition of a “security” from Cal. Com Code § 8102(1) (West 1977 & Supp. 1983) (i.e., an instrument in bearer or registered form, of a type commonly dealt in upon securities exchanges or markets or commonly recognized as a medium for investment, that is either one of a class or series or by its terms divisible into a class or series of instruments).


232. Id. § 510(a) (refers to purchases, redemptions, and other acquisitions of shares).

233. Id. This provision eliminates the concept of treasury shares from California law. See H. Ballantine & G. Sterling, supra note 207, at 8-79.

234. Cal. Corp Code § 510(b) (West 1977). If all of the authorized shares of any class or series are acquired, and their reissue is prohibited, then the articles of incorporation must be amended to eliminate any statement of rights related solely to such class or series.
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Directors of a California corporation who approve the making of a distribution to its shareholders contrary to the California tests and limitations, and who have not performed their duties in accordance with the California standard of performance in so doing, are jointly and severally liable to the corporation for the amount of the illegal distribution. Shareholders who receive a distribution prohibited by the California provisions with knowledge of facts indicating the impropriety thereof are liable to the corporation for the amount so received.

Directors sued for having made an illegal distribution may implead any other directors liable therefor and compel contribution, either in the same action or in an independent action. Directors liable for an illegal distribution are also entitled to be subrogated to the rights of the corporation against shareholders who received the distribution.

Any shareholder sued for knowingly having received an illegal distribution may implead all other shareholders liable therefor and may compel contribution, either in the same action or in an independent action.

**ii. Cost Implications of the California Provisions**

These provisions appear to impose on the groups interested in the amount of corporate financial distributions, and the groups involved in the administration of the provisions, costs that are less than those resulting for such groups from the operation of either the pre-1980 Model Act provisions or the Michigan provisions.

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235. Directors deemed to have approved the action are defined in *id.* § 316(a)(2) (West 1977 & Supp. 1983).

236. Section 316(a)(1) refers specifically to the provisions in *id.* §§ 500–503. *Id.* § 316(a)(1).

237. The standard of performance is set forth in *id.* § 309 (West 1977). Subsection 309(c) absolves the director from liability if the director meets the standards in subsections (a) and (b).

238. Section 316(d) of the California Corporations Code limits damages recoverable from the director to an amount not exceeding the liabilities of the corporation owed to nonconsenting creditors at the time of the violation and the injury suffered by nonconsenting shareholders. *Id.* § 316(d) (West 1977 & Supp. 1983).

239. *Id.* § 506(e) (West 1977). The subsection limits such shareholder’s liability to the liabilities of the corporation owed to nonconsenting creditors at the time of the violation and the injury suffered by nonconsenting shareholders.

Section 506(d) provides that nothing in this section affects any liability which a shareholder may have under the provisions of the California (Uniform) Fraudulent Conveyance Act. *Id.* § 506(d). Marsh states that “‘[t]his subdivision makes clear that these provisions [in the Corporations Code] are separate and independent from the Uniform Fraudulent Conveyance Act and that a plaintiff may sue under either or both if he can assert a cause of action under either or both.’” 2 H. MARSH, *supra* note 207, at 171. Compare the position of the Amended Model Act, discussed *infra* at text accompanying notes 295–96.


241. *Id.* § 316(f)(1).

242. *Id.* § 506(c) (West 1977).
As noted above, the California provisions mandate that, subject to any specific accounting treatment required by a particular section, accounting items necessary for application of the various tests and limitations are to be prepared or determined in conformity with generally accepted accounting principles. \(^{243}\) Relatively few of the mandated exceptions appear to translate into a required accounting treatment for specified transactions for purposes of financial statement preparation. \(^{244}\) Thus, it would appear that a California corporation requesting certification of its financial statements by a public accountant should incur little increased cost \(^{245}\) in that endeavor as a result of the operation of the California provisions.

It appears that lenders \(^{246}\) will be slightly less inclined to impose protec-
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tive covenants in long-term debt indentures entered into by California corporations than they would have been had the corporations involved been incorporated in either a balance sheet surplus or a Model Act jurisdiction. Thus, costs related to the insertion and enforcement of such covenants should be slightly lower than such costs for corporations incorporated in either a balance sheet surplus or a Model Act state.

California corporations that do not regularly prepare financial statements in conformity with generally accepted accounting principles.

247. Creditors probably do not place great weight on their perceptions of the permissiveness of the law of the debtor's state of incorporation in deciding whether to require covenants. Economy in such transactions requires covenants to be drafted for numerous transactions, and thus to cover transactions in the most permissive state. Credit losses and the availability of money obviously are also major influences on the decision to require covenants.

Nevertheless, several factors point toward the mildly reduced use of protective covenants by lenders. First, the new financial tests (i.e., those in CAL. CORP. CODE § 500(b) (West 1977)) are said to be modelled after restrictions placed on borrowers by institutional lenders, see Ackerman & Sterrett, supra note 207, at 1053 & n.7, and to that extent may serve to reduce the number of covenants inserted. Second, comparative analysis of the California provisions and the provisions in all other states shows a number of significant protections for creditors in the California act that are absent elsewhere (e.g., a conservative valuation standard—that prescribed by generally accepted accounting principles—is used in California, which results in a prohibition of the use of unrealized appreciation as a source for distributions; California subjects redemptions and purchases of shares to the same limitations that are imposed on dividends; California eliminates exceptions for certain types of repurchases of shares found in most statutes; California eliminates "nimble" dividends and dividends by wasting-asset corporations; and California eliminates possible distributions from surplus arising from reduction of stated capital). All such changes should make creditors less likely to impose protective covenants in cases where the cost-benefit analysis of such insertions was already fairly close prior to the California amendments.

On the other hand, close analysis of the California provisions will reveal that on certain occasions long-term lenders are not as well protected by the California Act as are preferred shareholders. See A. Frey, J. Choper, N. Lee & C. Morris, CASES AND MATERIALS ON CORPORATIONS 1056 (2d ed. 1977) (comparing permissible distributions by a corporation with substantial purchased goodwill and some retained earnings using alternatively preferred shares or long-term debt for long-term financing). It can also be argued that the California provisions may result in more installment repurchases of shares than would result under either the Model Act or the Michigan provisions. See infra notes 266-68. More importantly, the California provisions do not provide long-term creditors with the most common protection appearing in protective covenants, i.e., a limitation of distributions to net earnings after the loan in question. See Kummert, supra note 10, at 374. Furthermore, a recent empirical study demonstrates that the more stringent of the California tests, that of § 500(b), is a relatively poor predictor of whether the corporation will end up in bankruptcy. See Ben-Dror, supra note 215, at 387-404.

On balance, it appears that a mild reduction in the number of covenants imposed should nevertheless occur in those situations where the creditor is not regularly a long-term lender, where the debt involved is not large, where the costs of preparing such a covenant bulk large because of the probability of infrequent use, and where the term of the debt is relatively short.

248. In 1 H. Ballantine & G. Sterling, supra note 207, at 8-18 (footnote omitted) it is advised:

In applying these meanings to the various terms and in determining whether a corporation can make a distribution at any given time, however, the board of directors of a corporation (or anyone else attempting to determine whether a distribution can be made) should do so only on the basis of financial data prepared by an accountant or other person having professional compe-
must incur significant accounting costs to prepare such statements before they can even begin to consider whether a proposed distribution can be validly made. However, once those costs have been borne, such corporations, and those that already have recent financial statements based on generally accepted accounting principles, should find that the cost of advice concerning the legality of any proposed distribution other than an installment repurchase of shares will be less than it would have been had the corporation been incorporated in either Michigan or a Model Act state.

Counsel providing advice on a proposed installment repurchase of...
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shares by a California corporation must resolve a number of difficult substantive and planning issues:252 (a) whether any instrument issued to evidence the corporation's indebtedness on the repurchase should be negotiable,253 and if so, how a later transfer of the instrument to a holder in due course without notice254 of the purpose for its issuance will affect the corporation's ability to make distributions under the California tests and limitations;255 (b) whether the lien created by a mortgage given by the corporation to secure its indebtedness under the repurchase agreement is enforceable even though payments by the corporation on the indebtedness

exclusively within the accountant's area of expertise, see supra note 250, the issues presented by installment repurchases of shares are almost exclusively legal.

252. The discussion that follows does not concern itself with those purchases or redemptions of shares in which the corporation exchanges a negotiable debt security for such shares. CAL. CORP. CODE § 166 (West 1977) provides that such distributions are tested at the outset—the time when the shares are acquired. Apart from legal issues related to the determination of whether debt issued is a negotiable debt security, see supra note 230, such distributions are in effect treated by the California provisions as purchases or redemptions for property, and thus present issues like those discussed supra at note 250.

253. It appears that most corporations would prefer that any such note be non-negotiable, particularly in view of the possible consequences of a transfer of a negotiable instrument to a holder in due course without notice of the purpose for its issuance. See infra note 255. On the other hand, it appears that most selling shareholders would prefer the instrument to be negotiable, as such status appears to cost them little directly and provides obvious advantages in the event of later transfers. Given the possible consequences of a later transfer to a holder in due course, however, some corporations might pay less for the shares if the obligation is evidenced by a negotiable instrument.

254. It seems clear that corporations desiring to avoid the possibility of a transfer of a negotiable instrument to a holder in due course without notice can do so simply by conspicuously noting on the face of any such instrument that it was issued in connection with a repurchase of shares and that the corporation's ability to perform its obligations under the instrument are regulated by CAL. CORP. CODE § 500–503 (West 1977 & Supp. 1983). Such a statement appears to satisfy the "notice" required by CAL. COM. CODE § 1201(25) (West 1977 & Supp. 1983).

255. The California provisions provide no clear answer on this question. It is possible that the legislature intended that the general rule in CAL. CORP. CODE § 166 (West 1977) (i.e., that the time of a distribution by purchase or redemption of shares is the date cash or property is transferred by the corporation) be applied as payments are made on the instrument, since no exception appears therein for negotiable instruments transferred to holders in due course without notice. But that construction is inconsistent with the treatment afforded by the same section to shares acquired in exchange for negotiable debt securities (i.e., the time of such a distribution is the date when the corporation acquires shares in exchange for the debt securities). Marsh states that such outset treatment is necessary to avoid misleading future purchasers of the debt securities regarding their status as owners of an unconditional liability of the corporation. See 2 H. MARSH, supra note 207, at 161. A negotiable instrument issued in a repurchase transaction acquires the same unconditional status when it is assigned to a holder in due course without notice.

The treatment of negotiable instrument transfers most consistent with the general California distribution scheme appears to be an immediate reduction of the corporation's ability to make a distribution by the amount of the corporation's liability on the repurchase obligation. The corporation's retained earnings should be reduced by such amount and the obligation should be recognized (if it was not previously, see infra note 259) as a liability for purposes of the remaining assets test in CAL. CORP. CODE § 500(b)(1) (West 1977 & Supp. 1983). It is less clear how one reaches such results under the statute. Presumably one must find authority for such action in the implications of id. § 511, for such results are hard to square with the language in id. §§ 166 & 500.

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would be prohibited by one or more of the California tests and limitations;
256 (c) what types of provisions to insert in the repurchase agreement concerning the status of the selling shareholder\(^\text{257}\) in the event of extended default by the corporation on the repurchase obligation resulting from its inability to meet the California tests and limitations on required installments;\(^\text{258}\) (d) how to account for installment repurchases under the California provisions;\(^\text{259}\) and (e) what constitutes reasonable care by directors.

256. The United States Court of Appeals for the Ninth Circuit held in Walsh v. Patema \textit{(In re National Tile & Terrazzo Co.)}, 537 F.2d 329 (9th Cir. 1976), that a mortgage of real property given to secure a promissory note for a repurchase of shares was enforceable in the subsequent bankruptcy of the corporation even though the prior California law prohibited payments on the note itself. Marsh argues that the view of the dissent in \textit{National Tile} is a more accurate statement of prior law (that the arrangement was a device "to take the risk out of risk capital to the prejudice of present and future creditors") and that there was no intention on the part of the drafting committees to relax prior law on the subject. 2 H. \textit{MARSH}, supra note 207, at 160.

Note that if a mortgage lien can be enforced despite statutory prohibitions against making payments on the underlying indebtedness, counsel must then face the question of what effect creation of the lien had on the corporation's ability to make distributions. \textit{See supra} note 255.

257. The California Act provides no assistance on the question of the status of the selling shareholder during the term of the repurchase agreement. Marsh states that the selling shareholder holds "something other than an unconditional liability of the corporation." 2 H. \textit{MARSH}, supra note 207, at 161.

The Act is somewhat clearer on the status of the selling shareholder's shares during the term of the agreement. CAL. CORP. CODE § 510 (West 1977) provides that when a corporation purchases or otherwise acquires its own shares, such shares are restored to the status of authorized, unissued shares (unless the articles of incorporation require cancellation thereof). However, the Act is not clear as to when a corporation purchases or acquires shares under an installment repurchase contract. It appears that given the conditional nature of the corporation's liability, the shares usually would not be purchased or acquired until its obligation is satisfied. But the repurchase agreement can, of course, specify an earlier transfer of the shares to the corporation.

258. In \textit{Herwitz}, \textit{supra} note 98, at 314–15, the problem is discussed in the context of a former 50% shareholder faced with a surplus cut-off provision and possible planning techniques are suggested. Herwitz points out that the planning task becomes considerably less important if the cut-off involved is an insolvency limitation. \textit{Id.} at 314. See also the valuable discussion of the problem under the Model Act in \textit{Neimark v. Mel Kramer Sales, Inc.}, 102 Wis. 2d 282, 306 N.W.2d 278, 284–85 (1981).

259. The 1982 amendments to §§ 500, 502, and 503 of the California Corporations Code were made to accommodate the accounting entries that some accountants asserted were required by generally accepted accounting principles for a repurchase of shares for a promissory note: a reduction of the corporation's retained earnings, and an increase of the corporation's liabilities, both equal to the amount of the note. \textit{See 2 H. MARSH}, \textit{supra} note 207, at 136. Marsh states that "it was not certain that all accountants would agree with this treatment, or that it was the proper accounting treatment in light of the California statutory provisions." \textit{Id.}

The "proper" accounting entries for the repurchase transaction itself are in doubt. Marsh's statement, quoted \textit{supra} note 257, assumes that the corporation has a conditional liability on the repurchase. It is a fairly easy series of steps from that assumption to the accounting entries with which Marsh disagrees. Conditional liabilities fall within the category of what accountants call "contingent liabilities" (those dependent upon the occurrence of one or more future events to confirm their existence). Contingent liabilities are recorded as liabilities if information available at the time indicates that it is probable that a liability has been incurred and if the amount thereof can be reasonably estimated. \textit{See FASB ACCOUNTING STANDARDS}, 1973–1983, \textit{supra} note 182, at 1033 (Statement No. 238).
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in effecting such a transaction. These costs for advice may bulk as large as those for a Michigan corporation on such a transaction, but they should be less than such costs for a Model Act corporation on such a transaction.

A California corporation considering a proposed distribution must incur the cost of an analysis of its short-term cash flows to determine whether the proposed distribution may result in the corporation likely being unable to meet its liabilities as they mature. They must also bear

5, issued March 1975). The balancing debit, which in the past might have been made to “treasury shares,” under the California system is ultimately made to retained earnings. While such an entry would set up the possibility of double charges to retained earnings (once at the time of the transaction, and again as payments are made) which the 1982 amendments were designed to avoid, it may provide a more realistic picture of the corporation’s ability to make other distributions.

It is unfortunate that Marsh offers no hint as to what is “proper” accounting treatment of an installment repurchase. Assuming the method described above is incorrect, one is left with two other approaches. The first would adopt an alternate way of viewing the transaction and treat it as if it were a series of independent purchases in which the corporation’s liability on a particular purchase did not come into being until the corporation was able to satisfy the distribution limitations for that purchase. This view is consistent with the timing provisions in Cal. Corp. Code § 166 (West 1977) and does not appear to cause problems with the application of the tests and limitations in id. § 500–503 (West 1977 & Supp. 1983) to the transaction. But even assuming that extensive disclosure is made in the corporation’s financial statements regarding the transaction, such an approach appears to understate significantly the corporation’s long-term liabilities on its financial statements, and in most cases, is quite inconsistent with the expectations of all shareholders in the corporation concerning when the shares are acquired, what the parties’ rights are in the event of default, whether the shares vote, what the corporation’s ability is to make other distributions, etc.

A second approach would adopt the first view of the transaction, but with different entries. It appears appropriate to recognize the corporation’s liability at the time the transaction is entered into. However, the charge to retained earnings, given later reductions thereof as payments are made, perhaps should be replaced by a debit to a negative shareholder equity account (under some title like “shares subject to conditional repurchase obligation”). Pursuant to the amendment of id. § 500, the liability would be disregarded for application of the remaining assets tests.

260. Directors will be relying on opinions of counsel and independent accountants in entering into such transactions. Under Cal. Corp. Code § 309 (West 1977), directors may rely on such opinions in matters the directors believe to be within the professional’s competence, as long as they “act in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.” The issues presented above may require special inquiry into the professional’s competence to deal with them in order to satisfy the duty of reasonable inquiry.

261. Section 501 appears to raise issues not presented by the definitions of insolvency appearing in the Model Act (see supra text accompanying note 59) and the Michigan Act (see supra text accompanying note 153). Id. § 501. Thus, there may be some substantive difference in asking (as California does) whether as a result of a proposed distribution the corporation would be likely to be unable to meet its liabilities as they mature, rather than asking (as both the Model Act and the Michigan Act do) whether as a result of the distribution the corporation would be unable to meet its debts as they become due in the ordinary course of the corporation’s business. And, as previously noted (see supra note 217), there is a clear issue as to when payment of liabilities is “adequately provided for” under the California statute. But neither issue should result in substantial increases in counsel costs for corporations. The first at most means that a slightly lower probability of insolvency will trigger the California provision than is required for the other provisions. The second by itself should be productive of few disputes in operation. As Marsh points out, if a creditor has security for a debt, and thus

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the cost of directors' time devoted to the study of accountants' reports, lawyers' opinions, data on cash flows, and the possibility of directors' liability if the distribution is subsequently found to have been illegal. Such costs should be less than they would have been had the corporations been incorporated in either a balance sheet surplus or a Model Act state.

It appears that the costs for parties in the corporate solution related to proposed distributions abandoned after study should be less for California corporations than they would have been had such corporations been incorporated in either a balance sheet surplus or a Model Act state. The most significant of such costs are likely to arise in abandoned installment repurchases of shares. California's installment-by-installment test for most of such repurchases is easier to satisfy at the time of the making of the contract than the tests under either the Model Act or the Michigan Act. On the other hand, the California test also presents the selling shareholder with increased risks during the period of performance on the contract, as compared with the risks faced by a selling shareholder dur-

the debt is adequately provided for, the collateral for the secured creditor's debt is not available to meet liabilities of other creditors. 2 H. MARSH, supra note 207, at 150. Thus, a finding that a liability is adequately provided for may increase the probability of equitable insolvency. In any event, such issues must also be resolved under either the Model Act or the Michigan Act whenever secured creditors are in the picture.

On the general subject of the determination of whether a distribution will render the corporation insolvent, see the helpful comment of the ABA Committee on Corporate Laws, infra note 318, and Murphy, supra note 112, at 855–71.

262. See supra text accompanying note 114.

263. This test results from the definitions of the time of distribution appearing in CAL. CORP. CODE § 166 (West 1977). See supra text accompanying note 229.

264. This statement assumes that the Model Act is interpreted to impose its surplus test at the "outset" (i.e., the time when the repurchase obligation is entered into). See supra note 102. A requirement that the corporation have a sufficient surplus at the outset to cover its entire repurchase obligation should generally be more difficult to meet than the California requirement of meeting its tests and limitations at the outset for only the down payment on the repurchase obligation.

265. Section 367 of the Michigan Corporations Act, MICH. COMP. LAWS § 450.1367 (MICH. STAT. ANN. § 21.200(367) (Callaghan 1983)), mandates that its surplus test be applied at the outset to installment repurchases. Thus, the analysis discussed supra at note 264 also applies to comparison of an installment repurchase under Michigan's provisions and under the California provisions.

266. Assume that the installment obligation is not negotiable (or contains clear notice of the underlying transaction) and that the court's interpretation in Walsh v. Paterna (In re National Tile & Terrazzo Co., 537 F.2d 329 (9th Cir. 1976) regarding the enforceability of a mortgage given as security for the repurchase obligation is incorrect. See supra note 256. A selling shareholder entering into such a repurchase transaction with a California corporation faces the risk that either the limitations in CAL. CORP. CODE § 500 (West 1977 & Supp. 1983) (retained earnings, remaining assets alternative tests) or in id. § 501 (West 1977) (insolvency limitation) will prevent the corporation from performing on the obligation. But the shareholder's ultimate financial position may differ significantly depending on which provision prevents performance. If the insolvency limitation prevents the corporation from performing, the corporation probably will not survive. In such event, the shareholder, as holder of a claim subordinated to outside creditors, will probably realize nothing. On the other hand, if the corporation cannot satisfy either the retained earnings or the remaining assets tests
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ing such period under either the Model Act\textsuperscript{267} or the Michigan Act.\textsuperscript{268} As between these two factors, the first appears to be more significant in terms of its influence on the parties' decisionmaking.\textsuperscript{269} Thus, it would appear that fewer repurchases will be abandoned after study in California than would have been abandoned had the corporations involved been incorporated in either Michigan or a Model Act state.

Parties to a dispute over the impact of the California provisions on proposed or consummated distributions appear likely to incur similar costs\textsuperscript{270} in settling or litigating such disputes to those that would have been incurred had the corporation involved been a Michigan corporation.\textsuperscript{271}

Current or prospective shareholders of publicly held California corporations attempting to gauge prospects for the corporation's share price from changes in the corporation's dividend rate are likely to bear the same investment losses or additional information costs they would have borne had the corporations been incorporated in either a Michigan or a Model Act state.

\textsuperscript{267} Again, assume that the installment obligation is not negotiable, that a mortgage does not improve the selling shareholder's position, and that the Model Act applies the surplus test at the outset. Under such facts, the only risk the selling shareholder faces is the insolvency limitation (under \textsc{Model Business Corp. Act} § 6 (1979) the insolvency limitation applies as each payment is made in the installment obligation). In the event of corporate insolvency, the shareholder's fate is the same under the Model Act provisions as under California provisions. \textit{See supra} note 266. Thus, the selling shareholder dealing with a California corporation faces the increased risk (as compared to the risk presented by such a transaction with a Model Act corporation) that the tests in \textsc{Cal. Corp. Code} § 500 (West 1977 & Supp. 1983) may prevent the corporation from performing. But since such circumstances are not likely to be permanently disabling to the corporation, such risk appears only mildly increased over the risk the shareholder would have had in a transaction with a Model Act corporation.

\textit{discussion supra} note 189. Assuming that the repurchase was validly made, the selling shareholder during the period of performance on the contract has no greater risk than that borne by any other long-term creditor of the corporation. Such risks are much less than those borne by a selling shareholder under the California scheme. \textit{See supra} note 266.

\textsuperscript{269} The insolvency limitation has long been recognized to present risk to the selling shareholder in such transactions. \textit{See Herwitz, supra} note 98, at 305–11. Despite such risk, many repurchase transactions have been entered into, apparently because the parties believed that insolvency would not befall the corporation. Such action suggests that hurdles to entry into such transactions are more important than the possibility of later cut-offs.

\textsuperscript{270} Although the California provisions have relatively few ambiguities, they nevertheless present the potential for numerous disputes involving how some unusual transaction ought to be handled under generally accepted accounting principles. \textit{See B. Manning, supra} note 9, at 165 ("it is hard to muster confidence in a future role of California state courts as accounting tribunals"). Such issues appear generally analogous, in terms of litigation difficulty, to those presented when a Michigan corporation elects to use current value as the basis for a distribution.

\textsuperscript{271} As previously noted, \textit{see supra} text accompanying note 201, such costs for a Michigan corporation should be less than they would be if the corporation had been incorporated in a Model Act jurisdiction.
iii. Benefits Resulting from the California Provisions

The California provisions appear to provide greater benefits for the groups interested in the amount of corporate financial distributions and to groups involved in the administration of the legal limitations than are provided by either the Model Act or the Michigan Act. Senior security holders and creditors of a California corporation not subject to contractual distribution limitations are clearly better protected than they would have been had the corporation involved been incorporated in either Michigan or a Model Act state. Shareholders in publicly held California corporations appear to have the same prospects for stable dividends that they would have had if the corporations involved had been incorporated in either Michigan or a Model Act state.

These benefits appear to be less than the costs incurred by various parties as a result of the operation of the California provisions described above. But the relative balance of costs and benefits appears to be much closer under the California provisions than it is under either the Michigan or Model Act provisions. Thus, for most legislatures, they appear to be a viable alternative to distribution restrictions currently in operation.

b. Amended Model Business Corporation Act

i. Summary of Amended Model Act Provisions

The Amended Model Business Corporation Act imposes limitations

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272. See supra note 247 (discussion of aspects of California provisions pointing in such direction).

273. In terms of management flexibility to make distributions, California is a distant third behind the Michigan provisions and the Model Act provisions, respectively. Nevertheless, the presence of the alternative tests in CAL. CORP. CODE § 500(a) & (b) (West 1977 & Supp. 1983) appears to ensure that publicly held corporations pursuing the lagged-target payout approach discussed in Kummert, supra note 10, at 370–71, should be able to continue a target payout despite several years’ adverse earnings history.


The Committee on Corporate Laws has finished a complete revision of the Model Act. See Goldstein & Hamilton, The Revised Model Business Corporation Act, 38 Bus. Law. 1019 (1983). The authors say very little about the financial provisions in the Amended Model Act, implying that few changes are likely to be made in the amended financial provisions adopted in December, 1979. Id. at 1021–22.

Citations in the notes following will be to the Model Act, as amended in December, 1979, as set out in Amendments (1979), supra. Citations to sections of the Model Act not amended in 1979 are to
on the power of a corporation to make a "distribution" to its shareholders. A distribution is defined\(^{275}\) as a direct or indirect\(^{276}\) transfer of money or other property,\(^{277}\) or incurrence of indebtedness,\(^{278}\) by a corporation to

\[\text{Model Business Corp. Act (1979). Note that the Amended Model Act, when published in full, will change the section numbering of the Act.}\]


\(^{275}\) Amended Model Business Corp. Act \$ 2(i), Amendments (1979), supra note 274, at 1869.

\(^{276}\) The Committee Comments cite as an example of an indirect distribution a purchase by a subsidiary of parent company stock where the subsidiary's actions are controlled by the parent. See Amendments (1979), supra note 274, at 1868, 1878. Such purchases are said to be by the parent corporation.

The word "indirect" is also said to make "the definition apply to any other transaction in which the substance is clearly the same as a typical dividend or stock repurchase." Id. at 1878. Somewhat the same thought appears in the final words of the definition of a distribution (i.e., the words including as a form of distribution dividends, acquisitions of shares, or otherwise). Id. at 1869.

\(^{277}\) Section 2(i) of the Amended Model Act at this point excepts from the term "distribution" transfers of the corporation's own shares. Amended Model Business Corp. Act \$ 2(i), Amendments (1979), supra note 274, at 1869. The Committee Comments indicate that the exception is intended to exclude from the definition stock dividends, stock splits, and other "mere changes in the unit of interest." Amendments (1979), supra note 274, at 1878. The last phrase in this statement suggests that stock dividends for purposes of the exception may be limited to distributions of shares that effect "mere changes in the unit of interest,"—i.e., possibly only distributions of common shares upon common shares, or distributions of shares that do not change the proportionate interest of any existing class of shareholders of the corporation. But the amendments elsewhere appear to consider as "stock dividends" distributions of shares of a different class than that held by recipients. For example, § 18(b) of the Amended Model Act provides specific procedures to guard against effectuating changes in proportionate interests of classes by stock dividends. Amended Model Business Corp. Act \$ 18(b), Amendments (1979), supra note 274, at 1871. Thus, it appears that the reference to stock dividends in the comment is intended to be relatively broad.

The Committee Comments leave the characterization of transfers of shares upon conversion or exchange of shares in doubt. Are such transfers to be excepted from treatment as "distributions" only when they effect "mere changes in the unit of interest"? Two arguments may be offered against such a conclusion. First, if one accepts that distributions of shares affecting shareholders' proportionate interests are not statutory "distributions," it is hard to erect arguments as to why conversions or exchanges of shares should not also be excepted; the substantive consequences of conversions or exchanges of shares are virtually identical with disproportionate share distributions. Second, the amendments to § 18(b) described above appear to equate share dividends with conversions and exchanges of shares. Id.

The conclusion that all types of share dividends, and conversions and exchanges of shares, are not considered to be statutory "distributions" is supported by the general thrust of the definition of that term. The statute seeks to regulate transfers of cash and property and incurrence of debt by corporations. Viewed from the perspective of a creditor, paper shifts within the shareholders' equity section are in neither category. On the other hand, the arguments for permitting reshuffling of shareholder interests when the corporation is equitably insolvent (the condition in Amended Model Business Corp. Act \$ 45(a), Amendments (1979), supra note 274, at 1872) or has liabilities in excess of assets (the condition in id. \$ 45(b), Amendments (1979), supra note 274, at 1872) is scarcely compelling.

\(^{278}\) The Committee Comments indicate that inclusion of such a clause not only assures that distribution of a corporation's promissory obligations as a dividend will be treated as a distribution, but also indicates that on an installment repurchase of shares the incurrence of the indebtedness is the
or for the benefit of any of its shareholders in respect of any of its shares. A distribution may be in the form of a dividend, purchase, redemption or other acquisition of shares, or otherwise.

Under the Amended Model Act, a corporation may not make a proposed distribution if, after giving it effect, either: (a) the corporation would be unable to pay its debts as they become due in the usual course of business; or (b) the corporation's total assets would be less than the sum of its total liabilities and the maximum amount that then would be

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Amended Model Business Corp. Act § 45, supra note 274, at 1872. The Committee Comments state that the definition encompasses distributions in liquidation, including partial or complete and voluntary or involuntary liquidation. Amended Model Business Corp. Act supra note 274, at 1878. The amendments also change § 48 of the Model Act to delete subparagraph (c) (which imposed liability on directors for distributing assets during liquidation without the payment and discharge of, or making adequate provision for, all known liabilities of the corporation, see Model Business Corp. Act § 48(c) (1979)) and prescribe liability for directors who assent to any distribution contrary to the provisions of the Act and who do not comply with the standard of care prescribed in the Act. Amended Model Business Corp. Act § 48, supra note 274, at 1873. See also text accompanying notes 297-99. But the amendments make no change in § 87 of the Model Act, which continues to require that a corporation intending to dissolve to pay or adequately provide for the payment of its obligations before distributing assets to shareholders. Model Business Corp. Act § 87 (1979). Thus, under the Amended Model Act, directors considering a distribution in liquidation must satisfy both the provisions of amended § 45 and § 87 before the distribution can be validly made.

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Amended Model Business Corp. Act § 45(a), supra note 274, at 1872. The Committee Comments describe the equitable insolvency test as "the most important and fundamental test for the permissibility of distributions." Amended Model Business Corp. Act § 45(b), supra note 274, at 1872. The Committee Comments do not address the phrase. Its apparent purpose is to permit persons drafting the terms of shares with a liquidation preference to eliminate this protection. There is some reason to believe that such persons are not vigorous representatives on behalf of the interests of preferred shareholders (recall that preferred stock agreements had...
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payable in any liquidation in respect of all outstanding shares having preferential rights in liquidation.\(^{284}\)

A corporation's board of directors may choose\(^{285}\) to base determinations of its assets and liabilities for purposes of the second test upon either (i) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances,\(^{286}\) or (ii) a fair valuation or other method that is reasonable in the circumstances.\(^{287}\)

The date on which a distribution by purchase, redemption, or other acquisition of the corporation's own shares is tested\(^{288}\) under these provisions is the earlier of the dates on which money or other property is trans-

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\(^{284}\) AMENDED MODEL BUSINESS CORP. ACT § 45(b), Amendments (1979), supra note 274, at 1872. Note that the result of this provision is that a corporation must be able to satisfy both tests in order to make a proposed distribution.

\(^{285}\) See id. at 1883. It appears that the directors' choice between determining assets and liabilities upon the basis of financial statements prepared on the basis of reasonable accounting principles and a fair valuation is not itself subject to a determination of reasonableness.

The Committee Comments, although they describe this approach as "a departure from existing statutory provisions," id. at 1868, offer little justification for its approach beyond attempted clarification of uncertainties existing in many jurisdictions concerning the permissible way to determine assets and liabilities. Id. at 1883.

\(^{286}\) As to the difficulty in making this determination, see infra text accompanying notes 315–16.

\(^{287}\) The Committee Comments state that "the statute accordingly specifically authorizes departures from historical cost accounting and sanctions the utilization of appraisal methods for the purpose of determining the fund available for distributions." Amendments (1979), supra note 274, at 1885.

On the choice of approaches to determining current value, the Committee Comments state:

\[\text{It is inappropriate to apply a "quick sale" liquidation value to an enterprise in most cases, particularly with respect to the payment of normal dividends. On the other hand, a quick sale valuation might be appropriate in certain circumstances, for example, for an enterprise in the course of liquidation or course of reducing its asset or business base to a material degree. In most cases, a fair valuation method on a going concern basis would likely be appropriate, if expectations are that the enterprise will continue as a viable going concern.}\]

Id. The last phrase in Amended Model Act § 45, second paragraph (i.e., the acceptability of such other methods of valuation as are reasonable in the circumstances), was inserted to "comprehend the wide variety of possibilities that might not be deemed to fall under a 'fair valuation' but would be reasonable in the circumstances of a particular case." Id. No examples are offered.

\(^{288}\) AMENDED MODEL BUSINESS CORP. ACT § 45, para. 3, Amendments (1979), supra note 274, at 1872, says that the "effect of [such] a distribution shall be measured as of" the earlier of the dates it then describes. The Committee Comments state that it recognized the "need to specify the time at which the two tests imposed by section 45 should be measured." Amendments (1979), supra note 274, at 1885.

The Comments go on to say that "where shares of the corporation are acquired by it, a date approximating the earlier of the payment date or the date the shareholder ceases to be a shareholder with respect to such shares is to be used as the measuring date." Id. There appears to be no room in the statutory language for an interpretation accepting a date approximating the dates stated.
ferred, or debt is incurred, by the corporation,\textsuperscript{289} or the shareholder ceases to be a shareholder with respect to such shares.\textsuperscript{290} The date on which all other distributions are tested depends on how soon payment is made following authorization of the distribution: if payment occurs 120 days or less after the date of authorization, the distribution is tested on the date of authorization; if payment occurs more than 120 days after the date of authorization, the distribution is tested on the date of payment.\textsuperscript{291} Indebtedness\textsuperscript{292} incurred or issued by a corporation to a shareholder in a distribution that satisfies the tests prescribed in these provisions is, except to the extent subordinated by agreement, on a parity with corporate indebtedness to general, unsecured creditors.\textsuperscript{293} Shares of a corporation’s own stock acquired by it become authorized-but-unissued shares, unless the corporation’s articles of incorporation

\footnotesize{\textsuperscript{289} The Committee Comments state the following concerning the application of the tests to an installment repurchase of shares:

\textbf{[I]}n applying each of the tests of section 45, the legality of the distribution must be measured at the time of the issuance or incurrence of the debt, not at a later date when the debt is actually paid—though of course in some circumstances, such payment could constitute a preferential payment among creditors. In any later challenge arising out of the corporation’s subsequent insolvency, if the test of section 45 was properly met at the time of the incurrence or issuance of the debt, the directors would be entitled to rely fully upon the good faith business judgment rule of section 35, as discussed above.\textit{Amendments (1979), supra note 274, at 1886.}

\textsuperscript{290} In most purchases of a corporation’s own shares, it would appear to be a most unusual transaction when the dates on which the corporation transferred money or other property to the shareholder, or incurred indebtedness to the shareholder, were not earlier than, or identical to, the date when the shareholder ceased to be a shareholder with respect to such shares. The clearest case where the latter date is earlier would be presented by a call for redemption of preferred shares, coupled with the deposit of funds with a transfer agent to be used for such redemption, where the preferred shares’ agreement provides that such actions effect a cessation of the shareholder’s rights as a shareholder.\textsuperscript{291} \textit{Amended Model Business Corp. Act} § 45, para. 3, \textit{Amendments (1979), supra note 274, at 1872.} The Committee Comments provide no insight as to the significance attached to a 120-day gap between authorization and payment. Perhaps the provision is designed to force review by directors of current financial information in cases of an extended period between authorization and payment. But another result of the provision is to empower directors to authorize a conditional dividend simply by postponing the payment date more than 120 days. It is not evident what benefits are derived from such power.

It is not clear how these provisions are to be applied if the distribution involves a dividend of the corporation’s long-term debt to its shareholders. If the word “payment” is interpreted to mean the time at which money or other property is transferred by the corporation, then distributions of long-term debt would be measured at dates well beyond those apparently contemplated by the typical dividend pattern. Moreover, such postponed recognition of the debt would be directly contrary to the treatment mandated for repurchase debt (which is recognized much earlier under § 45 of the Amended Model Act). Perhaps for this purpose the word “payment” should be interpreted to include the making of the distribution, i.e., the date the debt is distributed to shareholders.\textsuperscript{292} Although the Committee Comments do not so state, it appears that the section must be referring to unsecured indebtedness incurred or issued by a corporation in a distribution.\textsuperscript{293} \textit{Amended Model Business Corp. Act} § 45, para. 4, \textit{Amendments (1979), supra note 274, at 1869.}
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prohibit their reissue. If the articles so provide, shares acquired are cancelled on acquisition, and the number of the corporation's authorized shares is reduced by the number of shares acquired. The corporation must thereafter file a statement of cancellation with the Secretary of State showing the reduction in its authorized shares.\(^{294}\)

Finally, the Amended Model Act offers adopting states the option\(^{295}\) of providing that in circumstances to which the distribution provisions of the Act are applicable, such provisions supersede the applicability of any other statutes\(^{296}\) of the state with respect to the legality of distributions.

Directors who vote for, or assent to,\(^{297}\) any distribution contrary to these provisions or to any restrictions contained in the corporation's articles of incorporation, and who have not complied with the Act's standard for performance of the duties of directors in so doing,\(^{298}\) are jointly and severally liable to the corporation for the amount of the distribution illegally made.\(^{299}\)

Any director held liable for making an illegal distribution is entitled to contribution from the shareholders who accepted or received any such distribution knowing it to have been made in violation of the Act, in pro-

\(^{294}\) Id. § 6, Amendments (1979), supra note 274, at 1869. The statement of cancellation must be filed not later than the time the corporation files its next annual report with the Secretary of State.

\(^{295}\) Id. § 152, Amendments (1979), supra note 274, at 1877. The provision is a new section. Former § 152 has been renumbered as § 153.

Of the two states that have thus far adopted the financial provisions in the Amended Model Act, New Mexico has adopted the optional provision, see N.M. STAT. ANN. § 53-11-44(E) (1983), and Montana has not, see Act of Apr. 21, 1981, ch. 475, 1981 Mont. Laws 876. Both states have the Uniform Fraudulent Conveyances Act in effect. See 7A U.L.A. 161 (1978), 31 (Supp. 1983).

\(^{296}\) The Committee Comments state:
The Committee does not believe, however, that it is appropriate for the Model Act to attempt directly to deal with a different uniform statute. In addition, if a corporation should become involved in proceedings under the federal bankruptcy laws following a distribution, the fraudulent conveyance provisions of section 67d (§ 548 effective October 1, 1979) of the federal Bankruptcy Act could become applicable to the transaction. It should be recognized that, while the Committee questions the desirability of inconsistency between the Model Act, on the one hand, and the Uniform Fraudulent Conveyance Act and the Bankruptcy Act, on the other, the Model Act deals fundamentally with the responsibility of directors, and failure to follow the standard of the Model Act results in potential liability for directors under section 48. In contrast, there is no provision in either the Uniform Fraudulent Conveyance Act or in the federal Bankruptcy Act for liability of directors; rather, the effect of those acts is to enable the trustee or other representative to recapture for the benefit of creditors funds distributed to others in some circumstances. Accordingly, considerations of public policy may justify the application of different standards in these two different sets of statutes. Amendments (1979), supra note 274, at 1883.

\(^{297}\) Directors who are deemed to have assented to an action are defined in MODEL BUSINESS CORP. ACT § 35, para. 3 (1979).

\(^{298}\) See id. § 35, para. 2.

\(^{299}\) AMENDED MODEL BUSINESS CORP. ACT § 48, para. 1, Amendments (1979), supra note 274, at 1873.
portion to the amounts received by them. Any director against whom a claim is asserted regarding an illegal distribution is entitled to contribution from other directors who voted for, or assented to, the action, and who did not comply with the Act’s standard of performance for duties of directors in so doing.

**ii. Cost Implications of the Amended Model Act Provisions**

The Amended Model Act provisions appear to impose on the groups interested in the amount of corporate financial distributions and the groups involved in the administration of the provisions costs that are less than those resulting for such groups from the provisions of any of the previously discussed acts.

Some Amended Model Act corporations that choose to expand their ability to make distributions by valuing assets on a basis other than generally accepted accounting principles are likely to bear increased costs in the event they seek certification of their financial statements. If the distribution would not have been permissible if assets had been valued under generally accepted accounting principles, it appears that such corporations face a difficult choice in the event the distribution is made: either their financial statements will show a deficit in their shareholders’ equity account, or their financial statements will receive an adverse opinion for containing asset write-ups on items not treated in accordance with generally accepted accounting principles. It appears that most such corporations will opt for the former and thus will bear only mildly

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300. *Id.* § 48, para. 2.
301. *Id.* § 48, para. 3.
302. It appears that in most cases the decision to use a basis other than generally accepted accounting principles will be made to expand the corporation’s ability to make distributions. But on occasion such a decision may result in contracting the corporation’s ability. Thus, a small corporation using the cash method of accounting may use that method even though it produces a smaller fund for distribution than that produced by the generally accepted accrual method. Such a corporation might conclude that the expense of preparing statements using generally accepted accounting principles was too great as compared to the benefits to be derived from having a larger fund for distribution.
303. This statement assumes that the equitable insolvency test is met on the distribution.
304. This statement assumes that the corporation has a single shareholders’ equity account (which seems to be the hope of one of the drafters of the Amended Model Act provisions, *see* B. MANNING, *supra* note 9, at 179–80). But even for a corporation with a single class of shares, it is not clear that accountants will produce statements with a single “shareholders equity” section. *See* B. MELCHER, *supra* note 84, at 116–17 (rejecting a single account in favor of separate accounts for shareholders’ contributions and earnings retained in the business). If two accounts are maintained, and if distributions are charged to retained earnings, a distribution in excess of the entire shareholders’ equity (i.e., one not permissible if assets had been valued under generally accepted accounting principles) will result in a deficit in retained earnings that is larger than the amount of shareholders’ contributions, and in an overall deficit in the shareholders’ equity section.
305. *See supra* note 182.
increased costs in securing credit and in procuring new shareholders. Such costs appear to be less than accounting costs resulting from any of the previously discussed acts.

Amended Model Act corporations should incur slightly greater costs related to the insertion and enforcement of contractual distribution limitations than would have been incurred had the corporations been incorporated under any of the previously discussed acts. Creditors and preferred shareholders are likely to perceive that they receive less protection under the Act than under other acts, particularly if states adopting its provisions generally accept its optional provision preempting

306. See supra note 184.

307. The Committee Comments make no reference to the impact of its provisions upon the need for contractual limitations. But Bayless Manning, a member of the subcommittee that drafted the revised provisions, has previously argued that such limitations are more effective in protecting creditors' interests than statutory legal capital machinery. See B. MANNING, supra note 9, at 106-08.

308. The provision in the Amended Model Act resulting in the primary reduction in the protection of creditors is the authorization in amended § 45(b), Amendments (1979), supra note 274, at 1872, of distributions by corporations so long as the corporation's assets (valued at either financial statement or fair valuation) exceed the corporation's liabilities (assuming a corporation with a single class of stock). This provision permits corporations to distribute the shareholders' contributions to the corporation, a possibility that is not directly authorized under any of the previously discussed acts. As to whether the Amended Model Act provisions are likely to effect a real reduction in the protection afforded creditors as compared to their status under the previously discussed acts, see infra note 310.

309. As previously noted, supra note 281, AMENDED MODEL BUSINESS CORP. ACT § 45(b), Amendments (1979), supra note 274, at 1872, authorizes provisions in a corporation's articles of incorporation that permit a distribution to be made even though the corporation's net assets after the distribution has been made will be less than the liquidation preference of preferred shares outstanding. Protections for the liquidation preference of such shares in previously discussed acts are not subject to this possibility. See supra text accompanying notes 46, 53, 73 & 163; text accompanying notes 217-19. Further, under all acts previously discussed, preferred shareholders had the protection of the retention in the corporation of assets equal to the stated capital attributed to common stock issued by the corporation. As noted above, supra note 308, the Amended Model Act takes away that protection.

310. It has been argued that at least under statutory systems based on legal capital, creditors receive no real protection because of the control that common shareholders have over the corporation's stated capital. See B. MANNING, supra note 9, at 84-88. But Manning also states:

The statutory provisions on stated capital and distributions to equity investors are expressions of a general norm of behavior to which the business community subscribes in principle . . . . Perhaps it may be argued that the statutes hang today in precisely the right balance. They announce a general and salutary principle which commands wide assent; but they are so feebly constructed and loosely enforced that a corporation's financial managers, lawyers, and accountants can move as they wish when it is necessary to do so, as everyone agrees one should be able to do. If this line of thought is valid, creditors do, in some general sense, benefit from the statutory scheme to the extent that the stated capital provisions contribute to an atmosphere in which corporate managements psychologically feel themselves inhibited from distributing assets to shareholders indiscriminately. Id. at 89 (footnote omitted). In time, managers operating under the Amended Model Act will no longer feel inhibited.
It can be anticipated that counsel representing such persons, in recognition of this fact, will more often insist on contractual distribution limitations (and possibly more stringent limitations) from Amended Model Act corporations than would have been the case had the corporations involved been incorporated under any of the previously discussed acts. Thus, costs related to such limitations should be higher for Amended Model Act corporations.

An Amended Model Act corporation should incur lower costs in determining the validity of a proposed distribution than it would have incurred had it been incorporated under any of the previously discussed acts. Counsel advising such a corporation on the most troublesome form of distribution under the Amended Model Act—an installment repurchase of shares—must resolve only the following issues in providing advice:

(a) how to apply the Act's equitable insolvency and remaining assets.

The Committee Comments, see supra note 296, concerning the optional provision are notable in the sense that while the Committee apparently would prefer that fraudulent conveyance statutes be superseded by corporate statutes, most of its statement argues against such a step. Indeed, nothing in the Committee Comments explains its desire for preemption apart from the need for directors to consider the different definition of insolvency set forth in Unif. Fraudulent Conveyance Act § 2, 7A U.L.A. 176 (1978). See Amendments (1979), supra note 274, at 1882.

The merits of the preemption section are discussed infra at note 354. But it seems clear that states adopting the Amended Model Act with the preemption section have significantly reduced protection of creditors.

312. The Committee Comments acknowledge the past difficulty in planning such transactions. See Amendments (1979), supra note 274, at 1886.

313. As previously noted, see supra note 276, the purchase of parent company stock by a subsidiary whose actions are controlled by the parent is an indirect distribution by the parent corporation. If, however, one reads Amended Model Business Corp. Act § 45(a), Amendments (1979), supra note 274, at 1872, to apply only to the parent corporation, an insolvent subsidiary could purchase the shares of a solvent parent corporation—surely a result that ought to be prohibited. Thus, it appears that amended § 45(a) ought to be interpreted to mean that indirect distributions by a subsidiary to the parent's shareholders are prohibited whenever either the parent or the subsidiary would be equitably insolvent after giving effect to the distribution.

314. The Committee Comments contain the following statement on the issue in its discussion of financial statement determinations of assets and liabilities:

Normally, a board of directors would use the corporation's separate "parent company" financial statements for such determinations of distributions. In the view of the Committee, a board of directors could properly use the equity method of accounting as set forth in APB No. 18 as to all of the corporation's investee corporations, including corporate joint ventures and subsidiaries, in the case of unconsolidated parent financial statements, although other evidence would be relevant in the total determination. Consolidated retained earnings (or "earned surplus") are usually the same as the parent company's retained earnings following such equity method of accounting under current accounting standards. Amendments (1979), supra note 274, at 1884. The first word of this quotation seems to indicate that in the Committee's view the choice of financial statements (i.e., the choice between parent company statements and consolidated statements) to be used in such circumstances is left to directors to determine according to the "reasonable in the circumstances" standard. The substantive content of that standard is discussed infra note 315.

The Committee's focus on retained earnings in the comment seems peculiar since that term appears
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tests to an installment repurchase of a parent corporation's shares by its subsidiary; (b) what guidelines to provide to directors for use in assessing whether the application of a particular set of accounting principles in preparation of financial statements,\textsuperscript{315} or of a particular valuation

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nowhere in \textit{AMENDED MODEL BUSINESS CORP. ACT § 45, Amendments} (1979), \textit{supra} note 274, at 1872. Furthermore, the statement appears to be inaccurate in any case in which the parent owns less than all of the stock in the subsidiary. That same qualification is necessary if one examines the effect of using parent-only financial statements (as compared to using consolidated statements) on the assets liabilities test present in \textit{id.} § 45(b). But an even more basic problem in using parent-only statements is that such statements contain receivables from and payables to the subsidiary, which are eliminated in the process of preparing consolidated statements. \textit{See, e.g.}, W. MEIGS, A. MOSICH & E. LARSEN, \textit{MODERN ADVANCED ACCOUNTING} 177–81 (1975). These factors indicate the choice may be more difficult than the Comments suggest.

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\textsuperscript{315} The Committee Comments state:

While the directors will normally be entitled to use generally accepted accounting principles and to give presumptive weight to the advice of professional accountants with respect thereto, it is important to recognize that the new Section requires the use of accounting practices and principles that are reasonable in the circumstances, and does not constitute a statutory enactment of generally accepted accounting principles. In the view of the Committee, the widespread controversy concerning various accounting principles, and their constant reevaluation, requires a statutory standard of reasonableness, as a matter of law, recognizing that there may be equally acceptable alternative solutions to specific issues as well as areas requiring judgment in interpreting such principles. This does not mean that the statute is intended to reject the use and reliance upon generally accepted accounting principles; on the contrary, it is expected that their use would be the basic rule in most cases. The statutory language does, however, require informed business judgment in the entire circumstances in applying particular accounting principles to the circumstances that exist at the time, for purposes of the ultimate legal measurement of the validity of distributions.

If a corporation's financial statements are not presented in accordance with generally accepted accounting principles, however, a board of directors should normally carefully consider the extent to which the assets may not be fairly stated or the liabilities may be understated, to determine the fairness of the aggregate amount of assets and the aggregate amount of liabilities. \textit{Amendments} (1979), \textit{supra} note 274, at 1884. Unfortunately, these statements do not shed much light on what substantive standard is implicit in “reasonable in the circumstances” apart from the suggestion in the last paragraph that fairness of the aggregate totals may be an element. But even that restatement leads one to ask, fairness from whose vantage-point? Creditors’? Shareholders’?

The questions become clearer in a specific context. Assume the corporation has prepared financial statements in accordance with generally accepted accounting principles and has consistently used the first-in-first-out (FIFO) method of valuing its inventory, a method generally accepted if it most clearly reflects the corporation’s periodic income. \textit{See FASB ACCOUNTING STANDARDS, JUNE 1973, supra note 84, at 16 (Accounting Research Bull. No. 43, ch. 4, statement 4, issued June 1953). That method also results, in periods of rising prices, in a higher inventory value being shown on the corporation’s balance sheet than would have appeared had the corporation used the last-in-first-out (LIFO) method of inventory valuation. One construction of \textit{AMENDED MODEL BUSINESS CORP. ACT § 45, Amendments} (1979), \textit{supra} note 274, at 1872, is that there must be some objective evidence to suggest that the use of the (FIFO) method was reasonable in the circumstances. Pursuing this view, the reference to fairness in subpara. 2 of amended § 45, \textit{id.}, could be interpreted to mean that reasonable people would agree that the valuation produced by FIFO was not excessive in the circumstances. Presumably such a conclusion would be reached in this example, despite the fact that the FIFO valuation exceeded the inventory value that would be produced under LIFO or average cost assumptions, because of the frequent use of FIFO by many different types of business enterprises.

There is, however, another more disturbing interpretation that can be placed upon reasonableness
method,\textsuperscript{316} for purposes of the remaining assets test is reasonable in the circumstances; and (c) what constitutes reasonable care by directors in effecting such a transaction.\textsuperscript{317} In addition, the corporation must bear the cost of an analysis of its short-term cash flows\textsuperscript{318} to determine whether the

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in the circumstances. The Committee Comments quoted above and elsewhere, see particularly Amendments (1979), supra note 274, at 1868, connect the notion of the directors’ informed business judgment with determinations of the corporation’s assets and liabilities under either the financial statement or fair valuation basis. (The Comments define in another context such judgment as acting “in good faith and with a reasonable basis for believing that the distribution authorized was permitted by the statute, after due consideration of what they reasonably believed to be the relevant factors.” Id. at 1882.) The reasonableness in the circumstances language and the business judgment rule in combination may mean that all determinations by directors of the accounting principles to be used in applying the test in AMENDED MODEL BUSINESS CORP. ACT § 45(b), Amendments (1979), supra note 274, at 1872, are reviewable only to the extent that the particular court is willing to investigate factors supporting a judgment by directors on any business issue. In some jurisdictions, the use of this interpretation would produce virtually no review of any decision the directors make short of actual fraud. See, e.g., Shlensky v. Wrigley, 95 Ill. App. 2d 173, 237 N.E. 2d 776 (1968). Even if the court reads more into the rule, as the Committee does in the quotation above, the court apparently will inquire only into whether the directors have “reasonable basis” for believing that the accounting principle they applied was “reasonable in the circumstances.”

A task force recently appointed by the ABA Section of Corporation, Banking, and Business Law to study a number of issues regarding legality of dividends appears to believe that the first construction of the Amended Model Act was intended by the committee. See Legality of Dividends, supra note 87, at 302. The task force questioned whether it is reasonable to require directors to make a judgment among accounting principles. It recommended that where financial statements based on generally accepted accounting principles are presented, they be conclusively presumed to be reasonable in the circumstances without the necessity of further judgment by directors. Id. at 303.

\textsuperscript{316} This portion of the statute produces exactly the source interpretation problems presented in connection with financial statement basis determinations. See supra note 315.

\textsuperscript{317} See generally MODEL BUSINESS CORP. ACT § 35, para. 2 (1979). The Committee Comments state:

The directors’ decision as to whether to authorize a distribution is to be judged on the basis of the business judgment rule; that is, whether the directors acted in good faith and with a reasonable basis for believing that the distribution authorized was permitted by the statute, after due consideration of what they reasonably believed to be the relevant factors.

Amendments (1979), supra note 274, at 1882. See also the Committee’s description of directors’ deliberations on equitable insolvency, set forth infra at note 318.

\textsuperscript{318} Consider the thoughtful advice on the subject in the Committee Comments:

In determining whether or not a corporation is, or as a result of a proposed distribution would be rendered, insolvent, the board of directors must exercise its collective business judgment as to whether making the distribution in question will render the corporation unable to pay its debts as they become due in the ordinary course of its business operations. In making this determination, the directors are required and entitled to make certain judgments as to the future course of the corporation’s business, including the likelihood that, based on existing and contemplated demand for the corporation’s products or services, it will be able to generate funds over a period of time from its operations or from any contemplated orderly disposition of its assets sufficient to satisfy its existing and reasonably anticipated obligations as they mature. The directors are entitled to expect that substantial indebtedness which matures in the near-term will be refinanced where, on the basis of the corporation’s financial condition and future prospects, and the general availability of credit to businesses similarly situated, it is reasonable to assume that such refinancing may be accomplished. To the extent that the corporation may be subject to asserted or unasserted contingent liabilities, the directors are required and entitled to make judgments as to
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proposed distribution will result in the corporation being able to meet its debts as they become due in the usual course of business. The cost of such an analysis should be no different for an Amended Model Act corporation than for a corporation incorporated under any of the previously discussed acts.

The features in the Amended Model Act that point toward a reduction in the cost of obtaining advice for directors—a simple, relatively permissive statutory structure, relative freedom from critical ambiguities, reduced risks for directors\(^3\) and shareholders\(^2\)—should also result in the likelihood, amount and time of any recovery against the corporation, after giving consideration to the extent to which the corporation is insured or otherwise protected by others against loss.

What is appropriate for an on-going business enterprise is a cash flow analysis based on a business forecast and budget for a sufficient period of time to permit a conclusion that known obligations of the corporation can reasonably be expected to be satisfied over the period of time that they will mature rather than a simple measurement of current assets against current liabilities, or a determination that the present estimated "liquidation" value of the corporation's assets would produce sufficient funds to satisfy the corporation's existing liabilities. In exercising their judgment, the directors are entitled to rely on information, opinions, reports and statements prepared by others, as contemplated by section 35.

Amendments (1979), supra note 274, at 1881-82. See also Murphy, supra note 112, at 855-71. Murphy raises, but does not resolve, a question counsel may have to address in providing instructions to persons gathering the cash-flow information: how long must a corporation be solvent after the distribution to escape operation of the statute?

319. The probability that directors who have been reasonably well advised will be held liable under the Amended Model Act for a corporate distribution appears extremely small. Well-advised directors will be apprised of the factors and projections, see supra note 318, to consider in making a determination, in their informed business judgment, of whether a proposed distribution will result in the corporation becoming equitably insolvent. The statute protects directors against challenge on the choice between financial statement basis and fair valuation basis for the determination of the corporation's assets and liabilities. If the statute is read to allow directors to use their business judgment in selecting either particular accounting principles, or a particular valuation approach, see supra note 315, and if directors may use business judgment in determining the actual values resulting under such methods (as the Committee so states, see Amendments (1979), supra note 274, at 1868), then a plaintiff attempting to establish a claim against directors must convince the court to attach liability to a decision entirely a matter of the business judgment of directors. Few courts are likely to do so.

The plaintiff's case is only slightly better if the directors' judgment concerning the use of particular accounting principles or a particular valuation approach is subject to some objective standard of reasonableness. In such a case, if the directors rely in good faith on the opinion of a competent lawyer or accountant that a particular treatment is reasonable in the circumstances, liability will not be imposed under § 35 of the Model Act. MODEL BUSINESS CORP. ACT § 35 (1979).

It also appears that directors who receive no advice in connection with a distribution are not likely to be found liable on the distribution. If the directors read the statute, and if the entire process is protected by the business judgment rule, it seems likely that directors would be liable only for distributions amounting to self-dealing transactions. The risk of director liability is increased if an objective standard of reasonableness is stated by the statute. If directors do not read the statute, it does not appear likely that many will, absent self-dealing motives, authorize distributions that violate such general tests as the equitable and (old) bankruptcy insolvency tests.

320. Under AMENDED MODEL BUSINESS CORP. ACT § 48, Amendments (1979), supra note 274, at 1873, any director held liable for making a distribution in violation of the Act is entitled to contribution from the shareholders who accepted or received the distribution knowing that it was made in
lower costs for Amended Model Act corporations for directors’ time related to distribution questions than would result under any of the previously discussed acts. The same features appear to have similar effects upon the possible costs for parties in the corporate solution related to transactions abandoned because of legal impediments or complexities and to litigation over proposed or consummated distributions.

General, unsecured creditors of Amended Model Act corporations which have made installment repurchases of shares and which have become insolvent before the repurchase obligations are satisfied are likely to suffer larger losses under these provisions than they would have suffered had the corporations been incorporated under either the pre-1980 Model Act or the California Act. Under both of those Acts, the corporation’s obligation to the selling shareholder is subordinated to obligations to general, unsecured creditors in the event of insolvency. But under the Amended Model Act (as under the Michigan Act), the obligation to the selling shareholder is accorded parity with obligations to general, unsecured creditors if at the time the obligation was incurred the distribution satisfied the Act’s tests. If such status is honored in bankruptcy, and if, as is typical, available corporate assets in such event are less than corporate indebtedness to general, unsecured creditors, payments to the selling shareholder by virtue of the operation of the Amended Model Act provision in such circumstances serve to reduce the amount received (and to increase losses suffered) by general, unsecured creditors.

violation of the Act, in proportion to the amounts received by them. Thus, to the extent that the Act has the effect of reducing the risks for directors, as is argued supra note 19, risks for shareholders are also reduced. In addition, the Act reduces significantly the risks for the selling shareholder in an installment repurchase of shares by eliminating any application of the insolvency test after the time of the making of the contract. See supra text accompanying notes 292–93. While such action does not insure that the selling shareholder will be paid in full, it does result (absent application of a fraudulent conveyance rule) in such person’s claim being treated on a par with general creditors’ claims in the event of insolvency—a very substantial enhancement of status as compared to the shareholder’s position if subject to the insolvency limitation.

Such is the effect of the pre-1980 Model Act and California provisions prohibiting any payment on a repurchase obligation that would render the corporation insolvent. See MODEL BUSINESS CORP. ACT § 6 (1979); CAL. CORP. CODE § 501 (West 1977); discussion supra notes 263–68.

Amended Model Business Corp. Act § 45, para. 4, Amendments (1979), supra note 274, at 1872.


The Committee Comments recognize that in some circumstances payment of the debt to the shareholder could constitute a preferential payment among creditors. See Amendments (1979), supra note 274, at 1886. In addition, it appears that even if the optional preemption provision is enacted, incurrence of such debt may be found to be a fraudulent conveyance under the Bankruptcy Act. See infra text accompanying notes 383–91.

See data discussed in Kummert, supra note 10, at 375 n.67.

The Committee comment states:

General creditors are better off in such a situation [i.e., an installment repurchase of shares] than
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Current or prospective shareholders of publicly held Amended Model Act corporations attempting to gauge prospects for the corporations’ share prices from changes in the corporations’ dividend rates are likely to bear the same investment losses or additional information costs they would have borne had the corporations been incorporated under any of the previously discussed acts.

iii. Benefits Resulting from the Amended Model Act Provisions

The principal benefits received by parties in the corporate solution from these provisions—the ability by corporations to maintain stable dividend rates despite recent adverse earnings performance, and the prohibition of distributions that would jeopardize payment of debts in the ordi-

Amendments (1979), supra note 274, at 1886. This assumes that the corporation at the time of entry into the repurchase obligation could have transferred cash or property to the shareholder for the shares and still remained a viable operating entity. That assumption may be true in some installment repurchases, but it does not appear likely in the vast majority of such arrangements. Initially, it may be noted that there is nothing in the operation of the Amended Model Act tests that suggests that a corporation entering into a valid installment repurchase could have transferred the entire purchase price in cash or property at the time of purchase. The corporation’s ability to satisfy the equitable insolvency test on any cash down payments made scarcely gives rise to the inference that the test would have been satisfied had the entire purchase price been paid at the outset. With respect to the possibility of transfers of property not affecting the corporation’s ability to pay debts as they arise in the ordinary course of business, the feasibility of such transfers is a function of the corporation’s ability to continue operating without the asset and the shareholder’s willingness to become the owner of an illiquid asset. Second, the assumption is contrary to the form in which the parties actually arrange such transactions. While there may be occasions when legal or tax factors may cause the parties to shift away from financially feasible forms of a transaction, such factors appear less significant in the setting of a typical share repurchase, i.e., one undertaken to terminate the shareholder’s participation in the enterprise. In such cases, the selling shareholder would ordinarily be delighted to receive cash or reasonably liquid property in exchange for his or her shares; if the actual transaction takes a different form, such result seems directly related to the corporation’s desire not to transfer the full purchase price at the outset. Third, even if general creditors as a group obtain some benefit from the retention of assets by some corporations when they might have been transferred, it appears that such benefit is more than offset by the prospect that controlling shareholders in financially troubled enterprises will increasingly turn to installment repurchases to improve their positions with the onset of financial difficulty. Such transactions offer shareholders in effect a form of option, because if the enterprise survives the period of difficulty the agreement can simply be rescinded. See Herwitz, supra note 98, at 309.

The Committee’s second line of argument in the final analysis depends on exactly the same considerations. It is doubtful that transitory ownership of property by the shareholder has any effect on such analysis. Cf. United States v. General Geophysical Co., 296 F.2d 86 (5th Cir. 1961), cert. denied, 369 U.S. 849 (1962).

Manning in effect argues that time saved by law teachers and law students (as compared to the time required to study provisions based on legal capital) is also an important benefit of the provisions. B. Manning, supra note 9, at 108.

As to the significance of such a benefit, see Kummert, supra note 10, at 370–71.
nary course of business\textsuperscript{329}—are the same as those received by participants from the operation of the pre-1980 Model Act and the Michigan provisions. These benefits appear to be less than the costs incurred by various parties as a result of the operation of the provisions. But, like California, the relative balance of costs and benefits appears much closer under the Amended Model Act provisions than it is under either the pre-1980 Model Act or the Michigan provisions. Thus, for most legislatures, the Amended Model Act provisions represent a viable alternative to distribution provisions currently in operation.

c. Minnesota Business Corporation Act

i. Summary of the Minnesota Provisions

The Minnesota Act\textsuperscript{330} imposes limitations on the power of a corporation’s board of directors to authorize, and the corporation to make, a “distribution.” A distribution is defined\textsuperscript{331} as a direct or indirect\textsuperscript{332} transfer of money or other property\textsuperscript{333} with or without consideration,\textsuperscript{334} or an

\textsuperscript{329} As to the significance of such a benefit, see id. at 364.

\textsuperscript{330} The purpose of this subpart of the article is to examine the operation of statutory restrictions on distributions based on the equitable insolvency test. In the United States currently there are two states with such patterns, Massachusetts and Minnesota. See \textit{Mass. Ann. Laws} ch. 1568, §§ 45, 61 (Michie/Law. Co-op. 1979 & Supp. 1983); \textit{Minn. Stat. Ann.} § 302A.551 (West Supp. 1983). The Minnesota Act was chosen for analysis because of its use of the basic structure of the Amended Model Business Corporation Act (i.e., par value is abolished; treasury shares are not recognized), its recent adoption, and its more comprehensive treatment of the subject.


\textsuperscript{332} For a discussion of the scope of indirect transfers under the source Amended Model Act provision, see supra note 276.

\textsuperscript{333} The statute at this point states “other than its own shares.” For a discussion of the scope of similar language in the Amended Model Act, see supra note 277.

\textsuperscript{334} This clause (which does not appear in the Amended Model Act) requires some interpretation as to which transfers of money or other property by a corporation to any of its shareholders with consideration are to be tested as “distributions” under the statute. The second sentence in \textit{Minn. Stat. Ann.} § 302A.011(10) (West Supp. 1983) includes in that category transfers of money or other property in which the corporation acquires its own shares. Determinations of whether other types of transfers of money or other property with consideration are to be considered “distributions” apparently must be made by testing the transfer to see if it is “in respect of [the corporation’s] shares.” \textit{Id.} That phrase is quite similar to language appearing in I.R.C. § 311(a) (Supp. V 1981), and it is possible that authorities interpreting the latter may help give content to the Minnesota language. See B. BITTKER \& J. EUSTICE, \textit{FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS} § 7.21 (4th ed. 1979).
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incurrence or issuance\textsuperscript{335} of indebtedness, by a corporation to any of its shareholders in respect of its shares. A distribution may be in the form of a dividend or a distribution in liquidation, as consideration for the purchase, redemption, or other acquisition of the corporation's shares, or otherwise.\textsuperscript{336}

The board of directors of a Minnesota corporation may authorize and cause the corporation to make\textsuperscript{337} a distribution only if the board determines that the corporation will be able to pay its debts in the ordinary course of business after making the distribution, and the board does not know before the distribution is made that the determination was or has become erroneous. The corporation may make the distribution if it is able to pay its debts in the ordinary course of business after making the distribution.\textsuperscript{338}

A determination by a corporation's board of directors that the corporation will be able to pay its debts in the ordinary course of business after making a distribution is presumed to be proper if the determination is made in compliance with the standard of conduct prescribed for directors of Minnesota corporations\textsuperscript{339} on the basis of financial information prepared in accordance with accounting methods, or a fair valuation or other method, reasonable in the circumstances.\textsuperscript{340}

A distribution may be made to the holders of a class or series of shares only if (a) all amounts payable to the holders of shares having a preference for the payment of that kind of distribution are paid; and (b) the

\textsuperscript{335} Act of Mar. 19, 1982, ch. 497, § 3, 1982 Minn. Laws 534, 535 added to \textsc{Minn. Stat. Ann.} § 302A.011(10) (West Supp. 1983) the words "or issuance" and deleted the words "or for the benefit of" that formerly followed "by a corporation to" and preceded "any of its shareholders."

The former change appears to have been made to avoid doubt as to the status of debt securities issued by a corporation pursuant to Article 8 of the Uniform Commercial Code. The latter change deletes words appearing in \textsc{Amended Model Business Corp. Act} § 2(l), \textit{Amendments (1979), supra} note 274, at 1869. The ABA Committee Comments offer no insight as to the range of transactions thought to be distributions as a result of the inclusion of the "for the benefit of" language. \textit{See Amendments (1979), supra} note 274, at 1878. But such language seems clearly intended to treat as a distribution any transfer of money or other property, or incurrence of indebtedness, to a third party that increases a shareholder's net worth. It is difficult to understand why such transactions should not be treated as distributions. Perhaps the Minnesota legislature believes that such transactions are another type of indirect transfer of money or other property to shareholders, and thus still are distributions.


\textsuperscript{337} The right of the board to authorize, and the corporation to make, distributions may be prohibited, limited, or restricted by, the corporation's articles of incorporation or bylaws, or an agreement. The rights and priorities of persons to receive distributions may also be established by any of such documents. \textit{Id.} § 302A.551(1).

\textsuperscript{338} \textit{Id.}

\textsuperscript{339} The statute adds that no liability under either its provision stating the standard for directors' conduct or its provision establishing liability of directors for illegal distributions will accrue if the requirements of subdivision 2 are met. \textit{Id.} § 302A.551(2).

\textsuperscript{340} \textit{Id.}
making of the distribution does not reduce the corporation’s remaining net assets below the aggregate preferential amount payable in the event of liquidation to the holders of shares having preferential rights, unless the distribution is made to those shareholders in the order and to the extent of their respective priorities. If the money or property available for distribution is insufficient to satisfy all preferences, distributions must be made pro rata according to the order of priority of preferences by classes and by series within those classes.341

The date on which the effect of a distribution by purchase, redemption, or other acquisition of the corporation’s own shares is measured is the earliest of the dates on which money or other property is transferred, or indebtedness payable in installments or otherwise is incurred, by the corporation, or on which the shareholder ceases to be a shareholder of the corporation with respect to the shares. The date on which the effect of any other distribution is measured is the date of its authorization if payment occurs 120 days or less following the date of authorization, or as of the date of payment if payment occurs more than 120 days following the date of authorization.342

341. Id. § 302A.551(4). The last sentence of § 551(4) appears contrary to the literal language of the restriction labelled (a) in text accompanying this note. That restriction, if applied literally, prohibits distributions if all amounts payable to shares with a preference on that kind of distribution are not paid. The last sentence, id. § 302A.551(4)(b), instructs how a distribution failing to meet this condition must be made. The conflict can be resolved by recognizing that the restriction labelled (a) is ambiguous as to the result when more than one class or series of shares has a preference over common shares. Assume a corporation has outstanding senior preferred shares entitled to receive a stated, cumulative dividend before any dividend is paid on either junior preferred or common shares; junior preferred shares entitled to receive a stated, cumulative dividend before any dividend is paid on common shares; and common shares. Also assume dividends have not been paid for some time on any class of shares. If the corporation proposes to pay a dividend only to the holders of senior preferred shares that will reduce, but not eliminate the arrearage to that class, can such a payment be made? The answer is yes if the last sentence overrides the restriction labelled (a), or if the restriction labelled (a) is read to permit distributions to holders of a class of shares if all amounts payable are paid to holders of shares with a preference senior to that of the holders of the proposed recipient class. The answer is no if the restriction is read literally and is thought to override the last sentence. It appears that the affirmative answer was intended. Compare the exception in id. § 302A.551(4)(a)(2).

342. Id. § 302A.551(3)(a), (b). These provisions are substantively identical to the provisions in the Amended Model Act. See supra text accompanying note 291. They present an ambiguity previously noted, see supra note 291, as to when the effect a distribution of the corporation’s long-term debt, not in connection with a reacquisition of shares, is measured. It was earlier argued that under the Amended Model Act, the effect of such a distribution should be measured no later than the date on which the debt is distributed to shareholders (i.e., that “payment” is synonymous with the making of the distribution for this purpose). See id. It is not clear that this is an appropriate construction of the provisions as they appear in the Minnesota Act. If it were accepted as an appropriate construction of the Minnesota Act, the effect of a distribution of long-term debt would be determined at the latest on the date of making the distribution to the shareholders. But such determination would be irrelevant because the distribution would have no current impact on the corporation’s ability to meet its short-term obligations. Thus, it would appear that “payment” for purposes of a test based only on cash-flows ought to be interpreted in this context to mean the date on which cash or property (other than
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Indebtedness incurred or issued by a corporation in a qualifying\textsuperscript{343} distribution to a shareholder, who as a result of the transaction is no longer a shareholder,\textsuperscript{344} is on a parity with the indebtedness of the corporation to its general, unsecured creditors, except to the extent subordinated, agreed to, or secured by a pledge of any assets of the corporation or a related corporation,\textsuperscript{345} or subject to any other agreement between the corporation and the shareholder.\textsuperscript{346}

Shares of a corporation’s own stock acquired by it become authorized but unissued shares, unless the corporation’s articles of incorporation provide otherwise. Any corporate debt (including the indebtedness of a corporation in a distribution to a shareholder who is no longer a shareholder) is on a parity with the corporation’s indebtedness to its general, unsecured creditors, except to the extent subordinated, agreed to, or secured by a pledge of any assets of the corporation or a related corporation, or subject to any other agreement between the corporation and the shareholder.

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\textsuperscript{343} For example, a distribution made in accordance with Minn. Stat. Ann. § 302A.551 (West Supp. 1983).

\textsuperscript{344} The Reporter’s Notes do not explain why the statute limits the parity clause to transactions in which the shareholder’s interest in the corporation is terminated. The remaining language in the clause is taken from the Amended Model Act. See id. reporter’s notes, at 191. One explanation may be that such a requirement was inserted to prevent, at least, more egregious attempts by controlling shareholders to provide themselves with an option of improving their position in event of insolvency without effective surrender of control. See supra note 326.

\textsuperscript{345} Minn. Stat. Ann. § 302A.011 (25) (West Supp. 1983) defines a “related corporation” of a specified corporation as a parent or subsidiary of the specified corporation or another subsidiary of a parent of the specified corporation. Section 302A.011(21) defines the “parent” of a specified corporation as a corporation that directly, or indirectly through related corporations, owns more than 50% of the voting power of shares entitled to vote for directors in the specified corporation. Id. § 302A.011(21). Section 302A.011(31) contains an analogous definition for “subsidiary.” Id. § 302A.011(31).

Section 302A.551(3)(c) states that if indebtedness issued by a corporation to a shareholder in a terminating reacquisition is secured by a pledge of a related corporation’s assets, the indebtedness will no longer be on parity with the corporation’s indebtedness to its general, unsecured creditors. Id. § 302A.551(3)(c). It is by no means clear why such a pledge should have any impact on the status of the debt within the corporation.

\textsuperscript{346} Id. § 302A.551(3)(c). Note that the Minnesota additions to the Amended Model Act language apparently resolve the ambiguity under the latter, see supra note 292, as to the status of indebtedness issued in a valid distribution that is secured. See Minn. Stat. Ann. § 302A.551 reporter’s notes, at 191, 196 (West Supp. 1983) (the latter indicating that the result in Tracy v. Perkins-Tracy Printing Co., 278 Minn. 159, 153 N.W. 2d 241 (1967), will be followed under the new section).
hibit their reissue. If the articles so provide, shares acquired are cancelled on acquisition, and the number of the corporation's authorized shares is reduced by the number of shares acquired. The corporation must thereafter file a statement of cancellation with the secretary of state showing the reduction in its authorized shares.

Directors who are present at the meeting and fail to vote against a distribution made in violation of the Minnesota provisions, or in violation of a restriction in the corporation articles or bylaws or in an agreement, and who fail to comply with the Minnesota standard of conduct for directors, are jointly and severally liable to the corporation for the amount of the distribution illegally paid. Shareholders who receive a distribution made in violation of the Minnesota provisions are liable to the corporation to the extent that the distribution received by them exceeded the amount that could have been legally paid.

A director against whom an action is brought for an illegal distribution may implead all other directors who voted for, or consented in writing, to the distribution and may compel pro rata contribution from them. Any such director may also implead all shareholders who received the distribution and may compel pro rata contribution from them.

Finally, Minnesota provides that these provisions supersede all other state statutes with respect to distributions.

348. Section 302A.559(1) also applies to directors who consent in writing to an illegal distribution. Id. § 302A.559(1). As to when a director may do so, see id. § 302A.233.
349. See id. § 302A.251.
350. The directors' liability under id. § 302A.559(1) is limited "to the extent the distribution exceeded the amount that properly could have been paid under section 302A.551." The latter section validates additional restrictions in the corporation's articles or bylaws, or in an agreement, but does not make such restrictions equivalent to statutory limitations. The statement in text seems to be what the drafters intended.
351. The reference in id. § 302A.557(1) is to a distribution in violation of id. § 302A.551. Apparently shareholders are thus not liable for distributions made in violation of restrictions in the corporation's articles or bylaws, or in an agreement. Compare id. § 302A.559(1), which defines directors' liability.
352. Note that this clause of id. § 302A.559(2) does not include all directors liable for an illegal distribution under id. § 302A.559(1) (i.e., those present at the meeting who fail to vote against or who consent in writing to a distribution).
353. Section 302A.559(2) of the Minnesota Act continues by adding "to the extent provided in section 302A.557, subdivision 1." Id. § 302A.559(2). The addition makes shareholders liable only to the extent the distribution exceeds the amount permissible under id. § 302A.551. See supra note 351.

The Minnesota provisions appear to impose on the groups interested in the amount of corporate financial distributions and the groups involved in the administration of the provisions costs that are slightly greater than those resulting for such groups from the Amended Model Act provisions, but less than those resulting for such groups from the provisions of any other previously discussed act.

The Minnesota provisions appear to raise only two issues for accountants asked to certify the financial statements of a Minnesota corporation: how to account for distributions in excess of the corporation’s shareholders’ equity; and how to account for an installment repurchase of shares when the repurchase does not terminate the shareholder’s interest in the corporation. Neither issue should significantly increase the corporation’s cost of obtaining certified financial statements. But corporations that make distributions in excess of shareholders’ equity may incur increased costs in securing credit and in procuring new shareholders because of accountants’ disclosures regarding such distributions. Such costs should be about the same as the accounting costs incurred by Amended Model Act corporations and less than such costs incurred by corporations incorporated under any of the other acts previously discussed.

Minnesota corporations should incur greater costs related to the insertion and enforcement of contractual limitations on distributions than would have been incurred had the corporations been incorporated under any of the acts previously discussed. Creditors receive less protection under the Minnesota Act than they would have received under any of the previously discussed acts. It thus appears likely that counsel advising

355. See supra note 304 (discussing the accounting options).

356. Apparently, indebtedness issued in such repurchases is subordinated in the event of insolvency to debt owed to general, unsecured creditors. See infra note 361. Such risk does not seem sufficient to treat the transaction as a conditional purchase. It therefore appears that the only accounting reaction to such transactions will be to disclose the transaction giving rise to such indebtedness and the status of the indebtedness in the event of insolvency.

357. A creditor’s position under the Minnesota Act appears to be even weaker than it is under the Amended Model Act (under which, as noted supra note 308, creditors receive considerably less protection than under other statutory systems). Minnesota has opted for precluding application of its fraudulent conveyances statute to corporate distributions. See supra note 354. Distributions may be made by a corporation with a single class of stock that result in the corporation’s liabilities exceeding its assets, as long as the immediate cash out-flow does not cause the corporation to become equitably insolvent. In the event of a distribution with such a result in connection with an installment repurchase of all of the shares owned by a shareholder (wherein the indebtedness is thereafter on a parity with indebtedness to the corporation’s general, unsecured creditors, see Minn. Stat. Ann. § 302A.551(3)(c) (West Supp. 1983)), creditors have been adversely affected as compared to their position on the same transaction with an Amended Model Act corporation.

Creditors of a Minnesota corporation with an outstanding class of shares with a liquidation preference are protected against such risk from installment repurchases of shares (except where the repur-
creditors dealing with Minnesota corporations will insist on contractual limitations on distributions more often than they might have had the corporations involved been incorporated under any of the previously discussed acts. The result of such insistence should be higher costs related to insertion and enforcement of such limitations.

A Minnesota corporation should incur costs in determining the validity of a proposed distribution that are greater than it would have incurred had it been incorporated under the Amended Model Act, but that are less than it would have incurred had it been incorporated under any of the other previously discussed acts. Counsel advising such a corporation on the most troublesome form of distribution under the Minnesota act—an installment repurchase of shares—must resolve the following issues in providing advice: 358 (a) how the Act’s provisions as to when the effect of a distribution is to be measured relate to its provisions as to when a distribution is permissible; 359 (b) how the Act’s equitable insolvency test applies


359. Minn. Stat. Ann. § 302A.551(3)(a) (West Supp. 1983) says that the effect of an installment repurchase of shares is to be measured as of the earliest of the dates on which money or other property is transferred, or indebtedness is incurred, by the corporation, or the shareholder ceases to be a shareholder with respect to the shares. In a typical installment repurchase involving a cash down payment at the closing, with simultaneous incurrence of indebtedness for the remainder of the purchase price and termination of the shareholder’s interest in the shares, all three dates coincide. Thus, under the dictates of id. § 302A.551(1) (“the corporation may make the distribution if it is able to pay its debts in the ordinary course of business after making the distribution”), the effect of such an installment repurchase on its equitable solvency is measured on that date.

That language may lead one to believe that the directors on the date of closing of a typical repurchase must investigate the effects of the distribution on the corporation’s solvency. But id. § 302A.551(1) apparently mandates a different result. Pursuant to the first sentence of subdivision 1, a distinction is drawn between the directors’ duties at the time the distribution is authorized and at the time the distribution is made (i.e., the date on which the effect is measured). The board at the time of authorization must make a determination, in accordance with § 302A.551(2) of the Minnesota Act, “that the corporation will be able to pay its debts in the ordinary course of business after making the distribution,” id. § 302A.551(1) (i.e., after the measurement date of the distribution). Such a determination is presumed to be proper if made by the directors in good faith compliance with the Minnesota standard of care on the basis of a broad range of financial data. Id. § 302A.551(2). Consequently, under the Minnesota standard, there is no liability of directors for an illegal distribution if these requirements are met. Id. Section 302A.551(1) of the Minnesota Act further states that the
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to an installment repurchase of a parent corporation’s shares by its subsidiary;\textsuperscript{360} (c) what status indebtedness incurred in a repurchase of part of a shareholder’s shares has in the event of insolvency;\textsuperscript{361} (d) what guidelines to provide to recipient shareholders as to circumstances in which they will be liable in connection with a distribution;\textsuperscript{362} (e) how long the corporation must be able to pay its debts in the usual course of business after making the distribution;\textsuperscript{363} and (f) what constitutes reasonable care by directors in effecting such a transaction.\textsuperscript{364} In addition, the corporation board must not know before the distribution is made that the determination was or has become erroneous. \textit{Id.} § 302A.551(1). It does not appear, however, that such knowledge affects qualification under the exculpatory subdivision (2), which looks only toward the determination that the corporation will be able to pay its debts. As to whether recipient shareholders are liable in such circumstances, see \textit{infra} note 362.

360. The issue is the same as that presented under the Amended Model Act. See \textit{supra} note 313.

361. \textsc{Minn. Stat. Ann.} § 302A.551(3)(c) (West Supp. 1983) implies that such indebtedness is always subordinated to indebtedness owed to the corporation’s general, unsecured creditors. Even if one views that subsection as inapplicable to indebtedness not resulting from complete termination of a shareholder’s interest, common law decisions on the same issue point to the same conclusion. See, e.g., Robinson v. Wangemann, 75 F.2d 756 (5th Cir. 1936). Query, however, as to what result will be obtained if such indebtedness is secured by a mortgage on the corporation’s assets. \textit{Compare} Tracy v. Perkins-Tracy Printing Co., 278 Minn. 159, 153 N.W.2d 241 (1967) (mortgage given by corporation to secure repurchase of \textit{all} shares held by a shareholder held valid where, at the time given, the corporation’s surplus exceeded the purchase price).

362. \textsc{Minn. Stat. Ann.} § 302A.557(1) (West Supp. 1983) provides that a shareholder who receives a distribution in violation of \textit{id.} § 302A.551 is liable to the corporation or to a director held liable on the distribution.

There appear to be circumstances in which shareholders receiving a distribution may be liable to the corporation even though directors were not liable to the corporation on the distribution. Assume that the distribution is an installment repurchase of shares in which there is a gap in time between the directors’ authorization and the date of closing of the transaction. As a result of the complicated relationship between \textit{id.} § 302A.551(3)(a) & (b) and \textit{id.} § 302A.551(1), see \textit{supra} note 359, directors on the date of authorization must make a determination of the corporation’s solvency on the measurement date for the repurchase, typically the closing date. Assume that such a determination has been made in good faith and with reasonable care, using appropriate financial information, and that the directors cause the corporation to make the distribution on the closing date, not knowing that the earlier determination has become erroneous. Section 302A.551(1) provides that such distribution is illegal because on the date of measurement, the closing date, the corporation is not able to pay its debts in the ordinary course of business after making the distribution. \textsc{Minn. Stat. Ann.} § 302A.551(1) (West Supp. 1983). In such circumstances, directors are not liable to the corporation. \textit{Id.} § 302A.551(2). But the shareholders \textit{are} liable to the corporation, even though they did not know that the distribution was illegal. See \textit{id.} § 302A.557(1); \textit{id.} § 302A.557 reporter’s notes, at 198.

On the other hand, if the distribution did not involve an acquisition of the corporation’s shares, and was paid within 120 days of authorization, recipient shareholders apparently would be liable only in the event that the directors are liable. In such a case the effect is measured at the date of authorization. See \textit{supra} note 359. If the conditions set forth above are met, neither directors nor shareholders are liable on such a distribution. \textit{Id.}

There is no apparent policy justification for such disparate treatment.

363. The issue is discussed in Murpny, \textit{supra} note 112, at 870.

must bear the cost of an analysis of its short-term cash flows to determine that the corporation will be able to pay its debts in the ordinary course of business after making the distribution.

The costs borne by Minnesota corporations and by parties in the corporate solution related to directors' time expended in connection with distributions and to transactions abandoned because of legal impediments or complexities should also be slightly greater than they would have been had the corporations been incorporated under the Amended Model Act. However, such costs will be less than they would have been had the corporations been incorporated under any of the other acts previously discussed.

General, unsecured creditors of an insolvent Minnesota corporation that has previously made and not satisfied an installment repurchase of shares that terminates the shareholder's interest in the corporation are likely to suffer larger losses under these provisions than they would have suffered had the corporation been incorporated under any of the previously discussed acts. Under the Minnesota Act, the obligation to such a

and budget for a sufficient period of time to permit a conclusion that known obligations of the corporation can reasonably be expected to be satisfied over the period of time that they will mature. "See Amendments (1979), supra note 274, at 1882. On the other hand, Minn. Stat Ann. § 302A.551(2) (West Supp. 1983) exculpates directors who have made a determination of solvency after the distribution in compliance with the Minnesota standard of conduct "on the basis of financial information prepared in accordance with accounting methods, or a fair valuation or other method, reasonable in the circumstances." That language appears to have been adapted from the Amended Model Act provision defining the permissible approaches for directors to valuing assets and liabilities for the remaining assets test. See Amended Model Business Corp. Act § 45(b), Amendments (1979), supra note 274, at 1872. It appears that for the most part such language should be disregarded, apart from "financial information prepared in accordance with [some] other method, reasonable in the circumstances." Minn. Stat. Ann. § 302A.551(2) (West Supp. 1983).

Another practical problem in providing advice to directors concerns the Minnesota provision that makes any distribution in violation of the provisions of any agreement a violation of statute. See id. §§ 302A.551(1), .559(1). The problem relates to the need to establish a system whereby all agreements thought to impose such restrictions can be segregated for easy review in conjunction with the decision to make a distribution. The problem is not presented by the more typical provision making distributions in violation of provisions in the articles of incorporation a violation of statute. See, e.g., Amended Model Business Corp. Act § 45, para. 1, Amendments (1979), supra note 274, at 1872.

365. Installment repurchases of less than all of the shares owned by the selling shareholder can also be made more freely under the Minnesota Act than under any of the previously discussed acts. See infra text accompanying note 367. But obligations incurred in such repurchases apparently are subject to subordination in the event of insolvency to claims of general, unsecured creditors. See supra note 361. Such protection is generally analogous to that afforded by the insolvency cut-offs in the Model Act, Model Business Corp. Act § 6 (1979), and the California Act, Cal. Corp. Code § 501 (West 1977). Such protection appears greater than that afforded by the parity rule in the Amended Model Act, Amended Model Business Corp. Act § 45, para. 4, Amendments (1979), supra note 274, at 1872, and the Michigan Act, Mich. Comp. Laws § 450.1367 (Mich. Stat. Ann. § 21.200(367) (Callaghan 1983)), in similar circumstances, except that in both cases there is an outset asset-liability test applied to the total repurchase. Thus, more non-terminating repurchases may occur under the Minnesota Act than would occur under either the Amended Model Act or the Michigan
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selling shareholder is accorded parity with corporate obligations to general, unsecured creditors if as of the time for measuring the effect of the repurchase the corporation is able to pay its debts in the ordinary course of business after making the repurchase. Because of the focus of this test on the corporation’s near-term cash flows and liabilities due in near future, and because of the parity rule, only the cash down payment on an installment repurchase of all of a shareholder’s shares is ever subject to the test. Each of the acts previously discussed apply one or more statutory limitations to the full purchase price in such a repurchase. It can therefore be anticipated that more installment repurchases will be entered into by Minnesota corporations than would have been entered into had such corporations been incorporated in any other jurisdiction. It also seems likely that a significant number of such repurchases will be by controlling shareholders of financially troubled corporations seeking only to improve their claim against the corporation in the event of bankruptcy. If the parity with general, unsecured creditors is recognized in bankruptcy, and if the corporate assets available are less than the corporation’s indebtedness to general, unsecured creditors, payments to the selling shareholder by virtue of the operation of the Minnesota provisions will reduce amounts received, and thereby increase losses suffered, by such creditors.

Current or prospective shareholders of a publicly held Minnesota corporation attempting to gauge prospects for the corporation’s share prices from changes in the corporation’s dividend rates are likely to bear the same investment losses or additional information costs they would have borne had the corporation been incorporated under any of the previously discussed acts.

Act, but creditors in event of insolvency are better protected under the Minnesota Act than they would be under either of the other two acts.

366. For the meaning of the term, see supra text accompanying note 341.

367. Thus, under the Model Act the full purchase price is tested against the corporation’s earned surplus and each installment thereof is tested by the insolvency limitation. See MODEL BUSINESS CORP. ACT § 6 (1979). Under the Michigan Act, the full purchase price is tested against the corporation’s surplus. See MICH. COMP. LAWS § 450.1365 (MICH. STAT. ANN. § 21.200(365) (Callaghan 1983)). Under the California Act, each payment on the full purchase price must meet either the retained earnings test or the remaining assets test, and must meet the insolvency test. See CAL. CORP. CODE §§ 166, 500–501 (West 1977 & Supp. 1983). Under the Amended Model Act, the full purchase price is tested against the corporation’s net assets (i.e., total assets less total liabilities, including the repurchase obligation). See AMENDED MODEL BUSINESS CORP. ACT § 45(b), Amendments (1979), supra note 274, at 1872.

368. See supra note 324.

369. See data discussed in Kummert, supra note 10, at 375 n.67.
iii. Benefits Resulting from the Minnesota Provisions

The principal benefits received by parties in the corporate solution from the Minnesota provisions—the ability of corporations to maintain stable dividend rates despite recent adverse earnings performance, and the prohibition of distributions that jeopardize payment of debts in the ordinary course of business—appear to be less than the costs incurred by such parties as a result of the operation of such provisions. In terms of the relative gap between costs and benefits, both the California Act and the Amended Model Act appear to have a closer balance of such items than the Minnesota Act. Nevertheless, for most legislatures, the Minnesota provisions represent a viable alternative to distribution provisions currently in operation.

B. Fraudulent Conveyance Law Restrictions on Financial Distributions

Financial distributions by corporations to shareholders are also subject to a complex pattern of federal and state fraudulent conveyance law provisions. Distributions by corporations voluntarily or involuntarily placed in bankruptcy may be recovered by the trustee in bankruptcy from recipient shareholders in two situations: (a) the distributions were fraudulent transfers under section 548 of the Bankruptcy Reform Act; or (b) the distributions were voidable under some other state or federal law by at least one unsecured creditor with an allowable claim against the

370. As to the significance of such a benefit, see id. at 370-71.
371. As to the significance of such a benefit, see id. at 364.
372. The cases discussed in footnotes throughout this part often do not characterize the transfer of property or incurrence of indebtedness involved as a dividend or a share repurchase or redemption. For purposes of discussion throughout this section, a “dividend” is deemed to have been paid by a corporation if money or other property is transferred, or indebtedness incurred, directly or indirectly, to or for the benefit of any of its shareholders without receipt of consideration. A share repurchase is deemed to have occurred if in connection with such a transfer or incurrence the corporation acquires a shareholder’s shares.
373. 11 U.S.C. § 301 (1982) requires that to commence a voluntary bankruptcy case, a petition must be filed by an entity that may be a debtor under the chapter under which relief is sought. The term “debtor” is defined generally in id. § 109(a), with further qualifications in id. § 109(b) & (d) for petitions under id. chs. 7 (liquidation) & 11 (reorganization). Business corporations incorporated in the United States can be “debtors” under either chapter. See 2 COLLIER ON BANKRUPTCY ¶ 109.01, at 109-4 to -5 (ch. 11) & ¶ 109.02, at 109-10 to -11 (ch. 7) (L. King 15th ed. 1983) [hereinafter cited as COLLIER].

There is no requirement that a debtor voluntarily filing a petition under 11 U.S.C. ch. 7 or ch. 11 (1982) be insolvent. See 2 COLLIER, supra, ¶ 101.26, at 101-43.
374. The rules for involuntary bankruptcy are for the most part contained in 11 U.S.C. § 303 (1982). See generally 2 COLLIER, supra note 373, ch. 303. Creditors need only prove that the debtor is “generally not paying [its] debts as [they] become due” or that a custodian was appointed or took possession of substantially all of the debtor’s property within the past 120 days in order to obtain relief. See 11 U.S.C. § 303(h) (1982).
corporation. Two state laws are typically invoked on behalf of such unsecured creditors: (1) state statutory or common law rules on fraudulent conveyances; and (2) state corporation law restrictions on distributions. Creditors of financially troubled corporations, of course, assert precisely the same theories outside of bankruptcy.

The relationship between the fraudulent conveyance rules and state corporation act restrictions on distributions has long been the subject of controversy. Debate on the issue was recently joined between Profes-

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375. 11 U.S.C. § 544(b) (1982). Creditors with certain claims not allowable may also be considered.

Section 544(b) is derived from former § 70e of the Bankruptcy Act (11 U.S.C. § 110(e) (repealed 1978)). See 4 COLLIER, supra note 373, § 544.03, at 544-13.


A third theory sometimes still invoked is the corporate trust fund theory. For a recent application, see American Nat'l Bank v. MortgageAmerica Corp. (In re MortgageAmerica Corp.), 714 F.2d 1266 (5th Cir. 1983).

377. Most state fraudulent conveyance statutes are based on the UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 161 (1978). The Uniform Act was approved by the National Conference of Commissioners on Uniform State Laws in 1918, see 7A U.L.A. 161 (1978), and is currently in effect in 26 states, see id. at 31 (Supp. 1983). In addition, 22 other states have statutes on fraudulent conveyances, most of which are modelled on 13 Eliz., ch. 5 (1570) (i.e., the statutes declare transfers with actual intent to delay, hinder, or defraud creditors to be fraudulent). ALA. CODE § 8-9-6 (1975); ALASKA STAT. § 34.40.010 (1975); ARK. STAT. ANN. § 68-1302 (1979); COLO. REV. STAT. § 38-10-117 (1973); CONN. GEN. STAT. ANN. §§ 52-552 (West 1960); FLA. STAT. § 726.01 (1981); GA. CODE ANN. §§ 28-201 (Harrison Supp. 1983); ILL. ANN. STAT. ch. 59, § 4 (Smith-Hurd Supp. 1983-84); IND. CODE ANN. § 32-2-2-14 (Bruns 1980); KAN. STAT. ANN. § 33-102 (1981); KY. REV. STAT. ANN. § 378.010 (Baldwin 1981); LA. CIV. CODE ANN. art. 1969 (West 1977); MISS. CODE ANN. §§ 15-3-3 (1972); MO. ANN. STAT. § 428.020 (Vernon 1952); N.C. GEN. STAT. § 39-15 (1976); OR. REV. STAT. § 95.070 (1981); R.I. GEN. LAWS § 6-16-1 (1969); S.C. CODE ANN. § 27-23-10 (Law. Co-op. 1976); TEX. BUS. & COM. CODE ANN. § 24.02 (Vernon 1968); VT. STAT. ANN. tit. 9, § 2281 (1970); WA. CODE §§ 55-80 (1981); W. VA. CODE ANN. § 40-1-1 (Michie 1982).

378. Only three states, Hawaii, Iowa, and Maine, do not have statutes on fraudulent conveyances. Courts in Hawaii and Maine have held that 13 Eliz., ch. 5 (1570) is part of their state's inherited common law. See Dee v. Foster, 21 Hawaii 1, 3 (1912); Butler v. Moore, 73 Me. 151, 154-55 (1882). The Iowa court appears to use a common law fraudulent conveyance rule. See, e.g., Rouse v. Rouse, 174 N.W.2d 660 (Iowa 1970).


380. Compare 2 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 604, at 1043-47 (rev. ed. 1940) (arguing that recipients of dividends were not donees, and thus not within the theory of fraudulent conveyances) and H. BALLANTINE, CORPORATIONS § 255, at 601 (rev. ed. 1946) (arguing the primacy of state dividend statutes) with Powers v. Heggie, 268 Mass. 233, 167 N.E. 314,
sor Clark, arguing that the fraudulent conveyance rules at a minimum should be interpreted to provide an additional set of restrictions on distributions, and the ABA Committee on Corporate Laws, questioning the desirability of inconsistency between the provisions in the Amended Model Business Corporation Act and the fraudulent conveyance rules. The remainder of this section will examine the bankruptcy fraudulent transfer provisions and a typical state (the Uniform) fraudulent conveyance act. It will then attempt to assess the costs and benefits of imposing the fraudulent conveyance rules as an additional set of restrictions on corporate distributions.


Section 548 of the Bankruptcy Reform Act authorizes the trustee in bankruptcy to avoid certain transfers of the debtor’s property, or obligations incurred by the debtor, made or incurred within one year of the date of the filing of the bankruptcy petition. Specifically, the statute authorizes the trustee to avoid any such transfer or obligation made or incurred (1) with actual intent to hinder, delay, or defraud any creditor (1929) (holding trustee in bankruptcy has power to recover dividends paid when corporation is insolvent and thus paid in violation of the Massachusetts (Uniform) fraudulent conveyance act).

Clark, The Duties of the Corporate Debtor to Its Creditors, 90 HARV. L. REV. 505, 558 (1977), suspects that some courts would wrongly decide that corporation law rules preempt application of the general fraudulent conveyance law even in the absence of a preemptive statute. Relatively few of the cases discussed in the following section have involved claims by plaintiffs alternatively stated under state corporation law and under fraudulent conveyance law. None of the cases containing such alternative claims have held the corporation law to preempt application of the fraudulent conveyance law. See Spanier v. United States Fidelity & Guar. Co., 127 Ariz. 589, 623 P.2d 19 (Ct. App. 1980) (transfer to former shareholders in connection with sale of shares held fraudulent conveyance; unnecessary to consider illegal dividend theory); Moseley v. Briggs Realty Co., 69 N.E.2d 7 (Mass. Jud. Ct. 1946) (dividend held to have been distributed in violation of corporation statute; dividend also gave rise to a cause of action for fraudulent conveyance, but statute of limitations had run); Crete Concrete Corp. v. Josephs, 66 Misc. 2d 837, 322 N.Y.S.2d 935 (Sup. Ct. 1971) (dividends violated both fraudulent conveyance law and state corporation law), modified, 39 A.D.2d 543, 332 N.Y.S.2d 601 (1972). See also United States v. 58th Street Plaza Theatre, Inc., 287 F. Supp. 475 (S.D.N.Y. 1968) (dividends violated state fraudulent conveyance law and a similar provision then in New York stock corporation law).

381. Clark, supra note 380, at 558.
383. 11 U.S.C. § 101(40) (1982) defines “transfer” for purposes of the Bankruptcy Reform Act generally to mean “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest.”
384. Id. § 548(a).
385. 11 U.S.C. § 548(a)(1) (1982) provides that both existing and future creditors of the debtor are defrauded by a transfer made with actual intent to hinder, delay, or defraud either class of creditor. See 4 COLLIER, supra note 373, § 548.02(03) n.9.
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of the debtor;\(^\text{386}\) or (2) without receipt of reasonably equivalent value\(^\text{387}\) if the debtor: (a) was insolvent on the date the transfer was made or obligation was incurred, or became insolvent as a result thereof;\(^\text{388}\) (b) was en-

\(^{386}\) 11 U.S.C. § 548(a)(1) (1982) is modelled on the first clause of former § 67e of the Bankruptcy Act, Act of July 1, 1898, ch. 541, § 67e, 30 Stat. 544, 564 (codified at 11 U.S.C. § 107(e); repealed 1978). Former § 67e provided that “all conveyances . . . made . . . by a . . . bankrupt . . . within four months prior to the filing of the petition, with the intent and purpose on his part to hinder, delay, or defraud his creditors . . . shall be null and void as against the creditors of such debtor.” Id. See also 4 COLLIER, supra note 373, ¶ 548.01[1] n.1.


388. 11 U.S.C. § 548(a)(2)(B)(i) (1982) was derived from former § 67d(2)(a) of the Bankruptcy Act, Act of June 22, 1938, ch. 575, § 1, sec. 67d(2)(a), 52 Stat. 840, 877 (codified at 11 U.S.C. § 107(d)(2)(a); repealed 1978). Section 548(a)(2)(B)(i) omits the language in the former section to the effect that such transfers were fraudulent only as to creditors existing at the time of transfer. 4 COLLIER, supra note 373, ¶ 548.03[5], at 548-45.

gaged in, or about to engage in, business for which the debtor's remaining property was an unreasonably small capital; or (c) intended to incur, or believed that the debtor would incur, debts beyond the debtor's ability to pay as such matured. The statute excepts, to the extent of value given, transfers or obligations otherwise invalid under its provisions that the transferee or obligee has taken for value and in good faith.

For purposes of section 548, a transfer is deemed to have been made when it has been so far perfected that no bona fide purchaser from the debtor would thereafter acquire any right in the property superior to rights of the transferee. "Value" is defined for purposes of the section as

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property, or satisfaction or securing of a present or antecedent debt of the debtor.\textsuperscript{393}

"Insolvent" is defined\textsuperscript{394} generally in the Bankruptcy Reform Act as a financial condition such that the sum of an entity's debts\textsuperscript{395} is greater than all of such entity's property at a fair valuation.\textsuperscript{396}


The bankruptcy fraudulent transfer provisions were originally derived from the provisions in the Uniform Fraudulent Conveyance Act (U.F.C.A.),\textsuperscript{397} and thus there are numerous similarities between the two propositions add to the statement in text that transfers not perfected as against a bona fide purchaser before the commencement of the case are deemed to occur immediately before the date of the filing of the petition.


\textsuperscript{394} The definition, appearing in 11 U.S.C. § 101(26)(A) (1982), applies only to an entity other than a partnership. The property to be valued excludes property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors and property that may be exempted from property of the estate under 11 U.S.C. § 522 (1982). 11 U.S.C. § 101(26)(A) (1982).

The use by the Bankruptcy Reform Act of the general definition of insolvency in determining fraudulent transfers supersedes the special definition of insolvency formerly found in § 67d(1)(d) of the Bankruptcy Act, which was applicable only to fraudulent transfers. Act of June 22, 1938, ch. 575, § 1, sec. 67d(1)(d), 52 Stat. 840, 877 (codified at 11 U.S.C. § 107(d)(1)(d); repealed 1978). The superseded definition strongly resembled the current definition of insolvency under the Uniform Fraudulent Conveyance Act (U.F.C.A.). See infra text accompanying note 408.

\textsuperscript{395} 11 U.S.C. § 101(11) (1982) defines "debt" as "liability on a claim." In turn, 11 U.S.C. § 101(4) (1982) defines "claim" to mean "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured" and rights to an equitable remedy for breach of performance that gives rise to a right of payment.


sets of provisions. Such differences as exist, however, relate to significant aspects of each set of provisions.

Under the Act, creditors are provided specified remedies if a debtor has made a conveyance, or incurred an obligation, that is fraudulent as to them. The Act contains no statute of limitations.

A conveyance or an obligation is fraudulent under the Act if made or incurred (1) with actual intent to hinder, delay, or defraud either present or future creditors; or (2) without receipt of a fair consideration if the

548 (1982) makes few substantive changes in former § 67d. See 4 COLLIER, supra note 373, § 548.01(1), at 548-8.


The remedies specified vary depending upon whether the creditor’s claim has matured or has not yet matured. Creditors with matured claims may have the conveyance set aside or obligation annulled to the extent necessary to satisfy their claims, or may disregard the conveyance and attach or levy execution upon the property conveyed. UNIF. FRAUDULENT CONVEYANCE ACT § 9(1), 7A U.L.A. 304 (1978). As to whether a creditor holding a matured claim may bring an in personam action under § 9, see Damazo v. Wahby, 269 Md. 252, 305 A.2d 138 (1973) (holding yes). Creditors whose claims have not matured may proceed against any person against whom the creditors could have proceeded had the claim matured. In such actions, the court may restrain the defendant from disposing of the property, appoint a receiver to take charge of the property, set aside the conveyance or annul the obligation, or make any other order the circumstances warrant. UNIF. FRAUDULENT CONVEYANCE ACT § 10, 7A U.L.A. 358 (1978).

The proposed U.F.C.A. combines the two provisions and makes available to creditors with matured claims the full range of remedies currently available under § 10 to creditors holding claims not matured. See Discussion Draft, supra note 397, § 6.

The Act defines “conveyance” to include “every payment of money, assignment, release, transfer, lease, mortgage or pledge of tangible or intangible property, and also the creation of any lien or encumbrance.” UNIF. FRAUDULENT CONVEYANCE ACT § 1, 7A U.L.A. 164 (1978). This definition is narrower than the definition of “transfer” in 11 U.S.C. § 548 (1982). See 4 COLLIER, supra note 373, § 548.01, at 548-12 to -13. The proposed U.F.C.A. provisions apply to “transfers.” See, e.g., Discussion Draft, supra note 397, § 4. The proposed provisions generally adopt the federal definition of “transfer” (see supra note 383), but change the last clause to read “and includes a transfer to a buyer that concurs with retention of title by the seller as a security interest.” See Discussion Draft, supra note 397, § 1(9).

Compare the one-year statute built into the federal provisions, see supra text accompanying note 384, with the proposed U.F.C.A. provisions which include a statute of limitations. See Discussion Draft, supra note 397, § 8(b).

Few states appear to have statutes specifically limiting actions related to fraudulent conveyances. Characterization of such actions for purposes of general limitations on actions has proved to be particularly troublesome in cases involving suits by the United States. See, e.g., United States v. Neidorf, 522 F.2d 916 (9th Cir. 1975).

UNIF. FRAUDULENT CONVEYANCE ACT § 7, 7A U.L.A. 242 (1978), states that actual intent is to be distinguished from intent presumed in law, and that a conveyance made or obligation incurred to defraud either present or future creditors is fraudulent as to both present or future creditors. The federal provision, discussed supra at note 385, is substantively identical to § 7 of the U.F.C.A., apart from the one-year federal statute of limitations. The proposed U.F.C.A. provisions refer to actual
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debtor either (a) is or will be thereby rendered insolvent, or (b) intends

403 or (b) intends


403. Section 4 of the U.F.C.A. adds “without regard to his [the debtor’s] actual intent.” Uniform Fraudulent Conveyance Act § 4, 7A U.L.A. 205 (1978). Section 4 also states that such conveyances or obligations are fraudulent “as to creditors.” Id. The last phrase has been interpreted to mean that the section protects only creditors existing at the time the transfer was made or the obligation incurred. See, e.g., T W M Homes, Inc. v. Atherwood Realty & Inv. Co., 214 Cal. App. 2d 826, 29 Cal. Rptr. 887, 896 (1963). 11 U.S.C. § 548 (1982) does not contain such a limitation. See supra note 388. The proposed U.F.C.A. provisions also limit protection to creditors who extended credit before the challenged transfer or obligation. See Discussion Draft, supra note 397, § 5.

or believes that the debtor will incur debts beyond the debtor’s ability to pay as they mature. A conveyance may also be fraudulent under the Act if made without receipt of a fair consideration by a debtor engaged or about to engage in a business for which the debtor’s property remaining after the conveyance is an unreasonably small capital.

“Fair consideration” has been given for the property interest conveyed, or obligation incurred, when either (a) in exchange and as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied, or (b) such property or obligation is received in...
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good faith to secure a present advance or antecedent debt not dispropor-
tionately small as compared to the value of the property or obligation.407

A debtor is insolvent under the Act when the present fair salable value
of the debtor’s assets is less than the amount that will be required to pay
the debtor’s probable liability on existing debts as they become absolute
and matured.408

differs in at least two significant ways from the notion of “value” or “reasonably equivalent value”
in 11 U.S.C. § 548 (1982): (1) under § 548, a transfer for security must be for a reasonably equivalent
value in order to be valid; under § 3 of the U.F.C.A., such a transfer is valid if its value is not
disproportionately large compared to the advance or debt secured; and (2) the “good faith” of the
transferee or obligee is not an element of the bankruptcy definition of value. The proposed U.F.C.A.
provisions provide generally that a transferee or an obligee gives value if such person transfers prop-
erty or satisfies or secures a present or antecedent debt of the debtor. See Discussion Draft, supra

Recent cases discussing the existence of “fair consideration” in connection with challenged corpo-
rate distributions include Pereira v. Checkmate Communications Co. (In re Checkmate Stereo &
Elec., Ltd.), 9 Bankr. 585 (Bankr. E.D.N.Y. 1981) (dividends) and Roxbury State Bank v. The

408. UNIF. FRAUDULENT CONVEYANCE ACT § 2(1), 7A U.L.A. 176 (1978). Section 1 of the
U.F.C.A. defines “assets” to mean “property [of the debtor] not exempt from liability for his debts.
To the extent that any property is liable for any debts of the debtor, such property shall be included in
his assets.” UNIF. FRAUDULENT CONVEYANCE ACT § 1, 7A U.L.A. 164 (1978). It is not clear under
this language whether property fraudulently conveyed is included in the debtor’s assets for this pur-
pose. See 4 COLLIER ON BANKRUPTCY ¶ 67.32, at 499–500 & nn.8–9 (F. Kennedy & L. King, 14th
ed. 1978); Landsers, The Bankrupt’s Spouse: The Forgotten Character in the Bankruptcy Drama,

Section 1 of the U.F.C.A. defines “debts” to include “any legal liability, whether matured or
unmatured, liquidated or unliquidated, absolute, fixed or contingent.” UNIF. FRAUDULENT CONVEY-

Courts have had difficulty determining how the U.F.C.A. insolvency test varies from the bank-
ruptcy and equity definitions of the term. The court’s discussion in Larrimer v. Feeney, 192 A.2d
351, 353 (Pa. 1963) (citations omitted), is frequently quoted on the matter:

Insolvency has two well tested meanings. In the bankruptcy sense, the test of insolvency is
purely mathematical and results when the aggregate value of the debtor’s property is less than
his liabilities. Insolvency in the equity sense, on the other hand, is the inability to meet obliga-
tions as they mature.

... The appellant asserts that so long as a debtor continues to pay his debts as they mature, re-
gardless of how he accomplished that object, and regardless of the fact that his liabilities are far
in excess of his assets, he is still solvent under the Pennsylvania act[, the U.F.C.A.]. The Pennsyl-
valnia cases have construed the foregoing definition as meaning that a person is insolvent
when he does not have the present ability to pay his debts and not when he is unable to trade on
credit. By the term insolvency is not to be understood an absolute inability to pay one’s debts at
some future time upon a settlement and winding up of all a trader’s concern, but a trader may be
said to be in insolvent circumstances when he is not in a condition to pay his debts as persons
carrying on trade usually do. The equity definition of insolvency conceives of it as a status or
condition to be differentiated from mere symptomatic occurrences such as chronic defaults in
current payments.

A reasonable construction of the foregoing statutory definition of insolvency indicates that it
not only encompasses insolvency in the bankruptcy sense i.e. a deficit net worth, but also in-

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3. Costs Resulting from the Imposition of Fraudulent Conveyance Rules as Additional Restrictions on Financial Distributions

Imposition of fraudulent conveyance rules as a supplement to state corporation law restrictions on corporate financial distributions will increase costs incurred by corporations for advice regarding the validity of a proposed distribution. Counsel asked to advise a corporation on the application of the fraudulent conveyance rules to a proposed repurchase of shares must resolve the following issues: (a) how to define for management and for appraisers the information necessary to apply the bankruptcy and U.F.C.A. insolvency tests to the proposed repurchase; (b) how to

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includes a condition wherein a debtor has insufficient presently salable assets to pay existing debts as they mature. If a debtor has a deficit net worth, then the present salable value of his assets must be less than the amount required to pay the liability on his debts as they mature. A debtor may have substantial paper net worth including assets which have a small salable value, but which if held to a subsequent date could have a much higher salable value. Nevertheless, if the present salable value of assets is less than the amount required to pay existing debts as they mature the debtor is insolvent.

See also McLaughlin, Application of the Uniform Fraudulent Conveyance Act, 46 HARV. L. Rev. 404, 420 (1933).

The proposed U.F.C.A. provisions state that a person is insolvent if the person is generally not paying the person’s debts as they become due, the person cannot pay the person’s debts as they become due, or the sum of the person’s debts is greater than the fair value of all of the person’s assets. Discussion Draft, supra note 397, § 2(a). The proposed provisions exclude from a person’s “assets” property which has been fraudulently transferred. Id. § 2(c). “Debt” is defined as “liability on a claim,” and “claim” is defined as “a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” Id. § 1(5), (3). The definition of debt is thus the same as the first paragraph of the current bankruptcy definition. See supra note 395.

There is some question as to whether the corporation and its decisionmakers will incur these expenses when liability for distributions made in violation of the fraudulent conveyance rules falls on shareholder-recipients. The corporation is chosen here on grounds that conscientious directors will attempt to avoid liability on the part of both directors and shareholders in connection with the distribution, and that most fraudulent conveyance cases appear to involve director-shareholders.

It appears from the cases involving the application of the fraudulent conveyance rules to corporate distributions that a proposed dividend is a likely subject for consultation. See, e.g., cases cited supra note 388. A proposed share repurchase has nevertheless been chosen for discussion to promote consistency with earlier analysis, and to present the broadest range of issues possible under the fraudulent conveyance rules.

Under the current bankruptcy definition, the critical data are the items of property to be included, the debts to be included, and the procedure for determining “fair valuation.” See supra notes 394–96. See also Consove v. Cohen (In re Roco Corp.), 21 Bankr. 429, 435 (Bankr. 1st Cir. 1982) (holding that treasury shares acquired in a challenged repurchase could not be included as an asset for purposes of application of the test). On “fair valuation,” see 2 COLLIER, supra note 373, § 101.26, at 101-54 to -65; 2 J. BONBRIGHT, THE VALUATION OF PROPERTY ch. 22 (1937).

Under the U.F.C.A. definition, the critical data are the items of property to be included, the debts to be included, and the procedure for determining “present salable value.” See supra note 408. On “present salable value,” see United States v. Gleneagles Inv. Co., 565 F. Supp. 556, 578 (M.D. Pa. 1983) (“The phrase means that value which can be obtained if the assets are liquidated with reasonable promptness in an arms-length transaction in an existing and not theoretical market.”); Fidelity
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apply such tests to a repurchase by a subsidiary of a parent's shares;\textsuperscript{412} (c) what constitutes an "unreasonably small capital" for the corporation;\textsuperscript{413} and (d) what facts lead courts to conclude that a debtor has made a transfer with intent to hinder, delay, or defraud creditors,\textsuperscript{414} or with intent to


Under the proposed U.F.C.A. tri-part definition of insolvency, \textit{see supra} note 408, counsel's task is increased by the need to describe for management and appraisers the bankruptcy standard and facts indicating when a person is not generally paying the person's debts as they become due. The second proposed standard is the equity definition of insolvency, which most counsel must consider as part of the state corporation law review of the proposed distribution.

412. Under the bankruptcy provisions, insolvency for an "entity" other than a partnership is defined in 11 U.S.C. § 101(26) (1982). Section 101(14) in turn defines "entity" as including a person, estate, trust, or governmental unit. \textit{Id.} § 101(14). Section 101(30) defines "person" to include an individual, a partnership, or a corporation. \textit{Id.} § 101(30). Assuming that grounds do not exist for disregarding the subsidiary's existence, these definitions seem to result in treating a subsidiary's acquisition of its parent's stock generally by analyzing the effect on the subsidiary level. Thus, if the transfer causes the subsidiary to become insolvent, and is made within one year of the date of the filing of the petition, the trustee has the four theories noted \textit{supra} in text accompanying notes 385-90 to use in setting aside the transfer. Such transfers may also be challenged under 11 U.S.C. § 547(b) (1982) as transfers to an insider. Suppose, however, the subsidiary is solvent after the purchase, but the parent is insolvent. It is hard to fit such an acquisition into the fraudulent conveyance categories of 11 U.S.C. § 548 (1982). Helpful analysis of the analogous problem of subsidiary guarantees of parent company debt appears in Coquillette, \textit{Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation}, 30 CASE W. RES. L. REV. 433 (1980); Rosenberg, \textit{Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware}, 125 U. PA. L. REV. 235 (1976).

The issues appear to be the same under the U.F.C.A. and the proposed U.F.C.A., except that neither has an equivalent of 11 U.S.C. § 547(b) (1982).

413. Examination of corporate distribution cases (\textit{see supra} notes 389 & 406), and authorities generally, does not shed much light on the standards by which unreasonably small capital is to be determined. Many of the cases involve transfers by insolvent corporations, and it is clear that an insolvent corporation has unreasonably small capital as a matter of law. \textit{See, e.g.}, Spanier v. United States Fidelity & Guar. Co., 127 Ariz. 589, 623 P.2d 19 (Ct. App. 1980). In the cases where a factual determination was made regarding whether capital remaining was unreasonably small, one can find authorities implying or stating that the test is a net worth test. \textit{See, e.g.}, Wells Fargo Bank v. Desert View Bldg. Supplies, Inc., 475 F. Supp. 693 (D. Nev. 1978) (stressing inadequate capitalization). On the other hand, a number of other cases focus entirely on the debtor's current assets and current liabilities, apparently reading the test as unreasonably small \textit{working} capital. \textit{See, e.g.}, Widett v. George, 336 Mass. 746, 148 N.E.2d 172, 175-76 (1958); Heffernan v. Bennett & Armour, 110 Cal. App. 2d 564, 243 P.2d 846 (1952). Clark, \textit{supra} note 380, at 555, interprets the test as a net worth test, which he then connects to insolvency: "the court must do its best to determine a level of capital which would provide a reasonable minimum level of protection against future decreases in the value of the debtor's assets and its subsequent inability to meet obligations to creditors."

Query whether the test is clarified by the language in the proposed U.F.C.A. provisions (assets remaining are unreasonably small in relation to the business). \textit{See supra} note 406.

414. Recent helpful discussion in a corporate distribution setting appears in Pirrone v. Toboroff (\textit{In re} Vaniman Int'l, Inc.), 22 Bankr. 166, 182-85 (Bankr. E.D.N.Y. 1982). Many of the distribution cases find intent from a transfer during insolvency of the corporate transferor. \textit{See, e.g.}, Consone v. Cohen (\textit{In re} Roco Corp.), 21 Bankr. 429, 435-37 (Bankr. 1st Cir. 1982). See also the discussion of proof of intent in 4 COLLIER, \textit{supra} note 373, § 584.02, at 548-33 to -41; and proposed U.F.C.A. §
incurred debts beyond the debtor's ability to pay as they mature.\textsuperscript{415} A corporation choosing to continue consideration of a proposed distribution after receiving such advice must presumably incur the cost of appraising assets\textsuperscript{416} to determine their "present fair salable value" and "fair value."

These costs, and the cost of directors' time to consider the advisability of the proposed distribution in view of such restrictions, are generally\textsuperscript{417} incurred as an addition to the corporation's costs in determining the advisability of the distribution in view of state corporate law restrictions. But there are at least two reasons\textsuperscript{418} to believe that relatively few corporations contemplating a distribution ever bear costs related to the advisability of a potentially fraudulent conveyance. First, the number of situations in which a distribution is permissible under state corporation law, but is prohibited by fraudulent conveyance rules, appears to be quite small.\textsuperscript{419} That

\footnotesize{\textsuperscript{4(b), Discussion Draft, supra note 455, § 4(b), that lists factors that may be considered in determining actual intent.}

\textsuperscript{415} The limited number of corporate distribution cases involving this provision (see supra notes 390 & 404) all use the provision along with virtually every other fraudulent conveyance rule in finding the transfers involved invalid. They all cite the same evidence used in connection with the other rules. The general authorities also are not particularly helpful on the proof questions. See 4 COLLIER, supra note 373, § 548.05, at 548-49 to -51.

\textsuperscript{416} On occasion, courts have found such values to be stated on the corporation's financial statements. See, e.g., Consone v. Cohen (In re Roco Corp.), 21 Bankr. 429, 435 (Bankr. 1st Cir. 1982).

\textsuperscript{417} The costs incurred in determining standards for, and asset values under, a fair value test may be used if the state corporate statute permits fair value determinations. See Mich. Comp. Laws § 450.1106(1) (Mich. Stat. Ann. § 21.200(106)(1) (Callaghan 1983)) (see supra text accompanying note 151); Amended Model Business Corp. Act § 45(b), Amendments (1979), supra note 274, at 1872 (see supra text accompanying note 287).

\textsuperscript{418} A third possible reason is that liability under the fraudulent conveyance rules generally falls only on shareholder-recipients, and not on the directors who decide to make such distributions. (It should be noted that an occasional state statute imposes penalties on any party participating in such transfers which presumably would include directors responsible for the transfer. See, e.g., S.C. Code Ann § 27-23-30 (Law. Co-op. 1976.) That fact may lead to mildly increased emphasis on the provisions that impose liability on directors: the state corporation laws.

\textsuperscript{419} Clark, supra note 380, at 557–60, appears to believe that a significant number of situations exist wherein distributions permissible under state corporation law will be found to violate fraudulent conveyance rules. His comparison is made with provisions in the pre-1980 Model Business Corporation Act. He argues that the unreasonably small capital test is stricter than the Model Act's surplus rules. Id. at 556–59. He seems to argue also that the U.F.C.A. insolvency test is stricter than the Model Act equitable insolvency test. Id. at 558. Examination of the cases applying fraudulent conveyance rules to corporate distributions appears to belie both arguments.

Only four of the corporate distribution cases discussing unreasonably small capital have involved only the fraudulent conveyance test. See supra notes 380 & 406. Of the four, Spanier v. United States Fidelity & Guar. Co., 127 Ariz. 589, 623 P.2d 19 (Ct. App. 1980) involved only the question of whether an insolvent corporation had unreasonably small capital as a matter of law. The facts in Wells Fargo Bank v. Desert View Bldg. Supplies, Inc., 475 F. Supp. 693 (D. Nev. 1978), seem to indicate that the dividend, a putative loan of $250,000, would have been illegal under the corporation statute (the corporation had a substantial deficit in retained earnings). The facts in In re Atlas Foundry Co., 155 F. Supp. 615 (D.N.J. 1957), involved a putative loan of $250,000 used to assist a shareholder's purchase of shares in which the transaction was designed to avoid legal restrictions otherwise preventing repurchase of the shares. In Widett v. George, 336 Mass. 746, 148 N.E. 172, 176 (1958),}
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factor, combined with a general lack of emphasis upon the fraudulent conveyance rules in corporation texts and planning guides makes it likely that corporate counsel will make state corporation law analysis determinative on such distributions. Second, situations clearly presenting potential violations of the fraudulent conveyance rules often do not get

the facts seem to show equitable insolvency. It seems reasonable to assume that application of the unreasonably small capital provision would bring an appeal. Thus, these cases appear to be a fair sample of the courts’ most strenuous attempts to apply the provision. And they seem to indicate that no case has thus far applied the unreasonably small capital provision in circumstances in which a typical state corporation statute would not have produced the same result.

On the argument that fraudulent conveyance tests for insolvency are more restrictive than the equitable insolvency test, it is generally assumed that divergences in results are likely to be greatest between the current bankruptcy test and the equitable insolvency test. But if one examines the federal cases applying the current bankruptcy test to corporate distributions, one is likely to find that a significant number offer evidence that the corporation involved was also equitably insolvent. See Consone v. Cohen (In re Roco Corp.), 21 Bankr. 429 (Bankr. 1st Cir. 1982) (total assets less than liabilities, but background of extensive cash flow problems); O’Connell v. Hoban (In re Famous Star Fair Meat Prods., Inc.), 19 Bankr. 48 (Bankr. E.D. Pa. 1982) (evidence of financial difficulties justified finding of both bankruptcy and U.F.C.A. insolvent); Pereira v. Checkmate Communications Co. (In re Checkmate Stereo & Elecs., Ltd.), 9 Bankr. 585 (Bankr. E.D.N.Y. 1981) (transfer of all corporation’s assets presumably resulted in equitable insolvency). Only Flanagan v. DeFeo (In re DeFeo Fruit Co.), 24 Bankr. 220 (Bankr. W.D. Mo. 1982), and Gennet v. Silver (In re Harry Kaiser Asso., Inc.), 14 Bankr. 107 (Bankr. S.D. Fla. 1981), do not contain clear evidence of equitable insolvency. But even in those two cases some evidence of current bill-paying difficulty was in the background. A similar pattern appears to have existed under the former bankruptcy test (“a person is ‘insolvent’ when the present fair salable value of his property is less than the amount required to pay his debts” (Act of June 22, 1938, ch. 575, § 1, sec. 67d(1)(d), 52 Stat. 840, 877 (codified at 11 U.S.C. § 107(d)(1)(d); repealed 1978)). See, e.g., Inland Sec. Co. v. Estate of Kirshner, 382 F. Supp. 338 (W.D. Mo. 1974) (evidence presented that corporation was not paying debts as they arose); In re Security Prods. Co., 310 F. Supp. 110 (E.D. Mo. 1969) (same).


421. See, e.g., 7 Z. CAVITCH, BUSINESS ORGANIZATIONS, WITH TAX PLANNING ch. 140 & § 155.02 (1983) (entire chapter on state dividend statutes, single paragraph in later chapter on fraudulent conveyances).
presented to lawyers; the desire by controlling parties to hurriedly rescue even a portion of their investment takes precedence over the demands of a deliberative process.\footnote{422. The sense that one gets from most of the corporate distribution cases involving fraudulent conveyance rules is that the situations are so egregious that competent, ethical counsel could not have been consulted on the transfer. Most involve acts of desperation, as Judge Kearse eloquently stated in \textit{Rubin v. Manufacturers Hanover Trust Co.}, 661 F.2d 979, 988–89 (2d Cir. 1981), about most fraudulent transfers:

When an overburdened debtor perceives that he will soon become insolvent, he will often engage in a flurry of transactions in which he transfers his remaining property, either outright or as security, in exchange for consideration that is significantly less valuable than what he has transferred. Although such uneconomical transactions are sometimes merely final acts of recklessness, the calculating debtor may employ them as a means of preferring certain creditors or of placing his assets in friendly hands where he can reach them but his creditors cannot. Whatever the motivation, the fraudulent conveyance provisions of § 67(d) of the Bankruptcy Act, 11 U.S.C. § 107(d), recognize that such transactions may operate as a constructive fraud upon the debtor’s innocent creditors, for they deplete the debtor’s estate of valuable assets without bringing in property of similar value from which creditors’ claims might be satisfied.}

A final\footnote{423. Applying the fraudulent conveyance rules as additional restrictions on corporate distributions should not increase the corporation’s accounting costs, or cause losses by preventing distributions in situations in which they would be generally beneficial. Such application would appear to have little effect on shareholder costs related to the information content of dividends, as few fraudulent conveyance cases involve publicly held corporations. See, as a possible exception, Powers v. Heggie, 268 Mass. 233, 167 N.E. 314 (1929).} cost implication of applying the fraudulent conveyance rules as an additional set of restrictions on corporate distributions concerns the possible effect of such application on the cost of resolving disputes over corporate distributions. It appears that many of the cases in which fraudulent conveyance rules were applied to corporate distributions could have been resolved with equal efficacy under state corporation statutes.\footnote{424. As noted \textit{supra} in note 419, most of the cases appear to present no serious issue under even the most liberal state corporation statute. It is, of course, fair to ask why more cases have not joined the two claims. See the limited number of cases cited \textit{supra} in note 380. Several reasons may be offered. First, state corporation statutes have only recently broadened the definition of a distribution to match the definition of a dividend adopted for purposes of this section. See \textit{supra} note 372, and the definitions in the California provisions (see \textit{supra} text accompanying notes 205–08) and in the Amended Model Business Corporation Act (see \textit{supra} text accompanying notes 275–80). Prior to such change, creditors may have had doubt as to whether an unexplained payment to a shareholder, not surrounded with the formality of a dividend declaration, was a “‘dividend’” for purposes of the state corporation law. Second, persons suing on behalf of creditors may be more attuned to remedies thought of as “‘creditors’ rights” (in much the same way that corporate lawyers advising directors may turn first to the corporation law). Third, as Judge Kearse’s statement in \textit{supra} note 422 indicates, financial pressures may cause persons in control of failing corporations to grab corporate assets or transfer them to friendly parties. Suit for recovery of the assets may be considered a more direct way of resolving the matter than a corporate law suit against directors, which may be followed by a suit for contribution from knowing recipients.} While the variation in state corporation statutes makes it difficult to generalize as to the relative costs of a fraudulent conveyance proceeding \textit{vis-a-vis} a state corporation law proceeding, the fact-laden content of the is-
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sues in fraudulent conveyance proceedings suggests that they often will be more expensive to conduct than a state corporation law proceeding.\footnote{Clark, supra note 380, at 557, states that "dividend restricting statutes are generally easier than fraudulent conveyance law for courts and shareholders to apply."}

4. **Benefits Resulting from the Imposition of Fraudulent Conveyance Rules as Additional Restrictions on Financial Distributions**

The incremental costs of adding fraudulent conveyance rules as a supplementary restriction on corporate distributions appear to be greater than the benefits to be derived from such action.

The primary benefit attributed to such addition is the possibility that unsecured creditors will have greater recoveries in the event of financial disaster than would accrue from the operation of state corporation laws.\footnote{See id. at 557–58.} However, it is not clear from the published fraudulent conveyance cases involving corporate distributions that this benefit exists to any significant degree.\footnote{See Landers, supra note 386, at 596, in which the author reaches the same conclusion.} While one can posit situations in which a distribution valid under state corporation law would be invalid under the fraudulent conveyance rules,\footnote{See Clark, supra note 380, at 556–57.} the courts appear to construe the principal provision portending such difference—the unreasonably small capital provision—so narrowly that few such differences seem likely to occur.\footnote{See supra note 419.}

It is also not clear that the difference in the classes of potential defendants under the respective statutes works to produce larger aggregate recoveries under the fraudulent conveyance rules than under the state corporation acts.\footnote{See supra note 422. Thus, practically, a suit against directors will reach the same persons sued under fraudulent conveyance rules on many occasions (perhaps most, if shareholders controlling directors' decisions are treated as directors).} Thus, the benefits from the addition of the fraudulent conveyance rules seem at best problematical.

State legislatures asked to address the question of making the state corporation law remedies exclusive face a difficult problem. Even if they agree with the assessment of costs and benefits set forth above, and take such action, the bankruptcy fraudulent conveyance rules will continue to be applied until Congress takes similar action. Congress, however, has evinced no interest in that direction, and may never do so in the face of variations in state dividend statutes and the argument that a single set of
(fraudulent conveyance) rules should regulate unfair transactions by financially troubled enterprises. Absent congressional action, state action to make state corporation remedies exclusive may have no effect other than lulling counsel into ignoring the bankruptcy provisions. Until Congress acts, it would appear to be better legislative strategy to adopt fraudulent conveyance rules that fully coordinate with the bankruptcy rules. Such action alerts counsel to the rules, and eliminates one level of tests on corporate distributions.

IV. CONCLUSION

Legislatures reevaluating statutes regulating financial distributions by corporations to shareholders should be able to reach consensus on two major issues in any such inquiry with relative ease. The issue of whether any change is required in the state's corporate financial provisions should receive a resounding affirmative answer from the legislature in any state currently basing such provisions on legal capital. The analysis set forth above indicates that a number of alternative systems not based on legal capital will provide a more favorable balance of costs and benefits than those resulting from the operation of either of the major systems based on legal capital. Second, the issue of whether any change is required in the state's fraudulent conveyance act should also receive an affirmative answer. The analysis set forth above indicates that pending Congressional revision of the bankruptcy fraudulent transfer rules, benefits will be obtained and costs reduced by amending state fraudulent conveyance rules to coordinate with the bankruptcy rules. The proposed revision of the Uniform Fraudulent Conveyance Act provides an excellent model for such change.

Legislatures deciding to alter their corporate financial provisions must then face the more difficult question of which of the alternative systems not based on legal capital should be chosen. That choice is confounded by the superficial similarities between the three principal alternative systems, and more importantly, by the relative imbalance between benefits and costs of such systems.

The three principal alternative systems do indeed have some remarkable similarities. All three proceed from a common assessment of the inadequacies of the concept of legal capital to abolish not only the statu-

431. See Clark, supra note 380, at 558.
432. As is clear from the analysis of the proposed U.F.C.A. provisions, this appears to be an important objective in the revision.
433. See generally Discussion Draft, supra note 397; supra Part III.B2.
434. See 2 H. MARSH, supra note 207, at 123–24, concerning the views of the California draf-
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tory underpinnings of the concept (the notion of par value and accounting rules for consideration received for shares), but also the series of exceptions (nimble dividends, depletion dividends, and special repurchases of shares) and fictions (treasury shares) erected because of the existence of the concept. All three subject transfers of cash or property, or incurrences of indebtedness, by a corporation without consideration to its shareholders to a single set of restrictions, regardless of the form in which the transfer, or incurrence, occurs. All three address applications of the restrictions to such transfers, or incurrences, where the transferor, or obligor, is either the parent, or the subsidiary, of another corporation. Finally, drafters of each of the systems based their efforts on the premise that statutory systems founded on legal capital were essentially misleading insofar as they led creditors and senior security holders to believe that such systems operated to protect their interests.

435. CAL. CORP. CODE § 205 (West 1979 & Supp. 1983) provides that solely for the purpose of any statute imposing any tax or fee based upon the capitalization of a corporation, all authorized shares of a California corporation will be deemed to have a nominal or par value of $1 per share. The Amended Model Business Corporations Act provides alternative provisions basing franchise taxes on either the amount of the stated capital of a corporation determined under accounting practices and principles that are reasonable in the circumstances, or the number of shares issued and outstanding. See AMENDED MODEL BUSINESS CORP. ACT § 132, Amendments (1979), supra note 274, at 1876–77. Minnesota does not impose such taxes.


437. See 2 H. MARSH, supra note 207, at 124–25; MINN. STAT. ANN. § 302A.551 reporter’s notes, at 191 (West Supp. 1983). The comment of the ABA Committee on Corporate Laws does not address the deletion of the concept of nimble dividends. Such dividends were permitted under former Model Act § 45(a) (alternative), which was presumably deleted with the deletion of former § 45. See AMENDED MODEL BUSINESS CORP. ACT, Amendments (1979), supra note 274, at 1872.

438. See 2 H. MARSH, supra note 207, at 125–27. The comments of the ABA Committee on Corporate Laws and the Minnesota reporter do not refer to deletion of the depletion dividend provision.

439. See 2 H. MARSH, supra note 207, at 127–29. The comments of the ABA Committee on Corporate Laws and the Minnesota reporter do not refer to deletion of the special repurchase provisions.


441. The notion of a centralizing concept of a "distribution" is common to all three acts. See supra text accompanying notes 204, 275 & 331.

442. As noted supra in notes 226, 314 & 360, the acts do this with varying degrees of success.

The analysis above indicates that despite these similarities, the three systems can be clearly distinguished on the basis of their respective responses to that possible misrepresentation. The California series attempts to rectify the misrepresentation by promulgating rules that will provide creditors and senior shareholders with the type of protection they thought they were getting from the legal capital system. On the other hand, the Amended Model Act and the Minnesota Act both attempt to rectify the misrepresentation by promulgating rules that will provide creditors and senior shareholders with the level of protection that the drafters perceived such groups actually received from the legal capital system. This variance in fundamental goals in turn produces the significant differences between the Acts on such issues as the relative freedom directors have and the status in the event of financial difficulty of debt issued on repurchase of shares.

The preceding analysis indicates that despite significant efforts at reform, there appears to be an imbalance between the costs related to the systems not based on legal capital and the benefits obtained thereby. That imbalance may be the result of errors in my assessment of costs related to the operation of the two systems (California, Amended Model Act) with relatively small imbalances, or in my weighting of the benefits obtained from such operation. I have the sense, however, that the imbalance remains in significant part because of the attempt by the current reform efforts to apply the same standards to all types of corporations. The result is a series of provisions that tend not to work terribly well for either smaller, closely held corporations or larger, publicly held corporations.

Another factor undoubtedly contributing to the imbalance is that the list of benefits does not assign a value to the possibility that the operation of a particular set of financial provisions will result in the long-term survival of more corporations than would have survived under the operation of other provisions. A recent study provides the insight that application of the California alternative provisions would have prevented distributions by a significant number of corporations that subsequently went bankrupt. It suggests that similar effects would not have occurred under the

444. See 2 H. Marsh, supra note 207, at 124.
445. This view is not stated directly by either the ABA Committee on Corporate Laws or the Minnesota reporter. However, both identify the equitable insolvency test, part of most statutory systems based on legal capital, as "the fundamentally important test." See Amendments (1979), supra note 274, at 1868; Minn. Stat. Ann. § 302A.551 reporter's notes, at 192 (West Supp. 1983).
447. See supra discussion in text accompanying notes 321-23.
448. See Ben-Dror, An Empirical Study of Distribution Rules Under California Corporations
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Amended Model Act provisions. While the study does not conclusively demonstrate that imposition of the California alternative tests will result in more corporations surviving within the adopting state, it does seem to indicate that such provisions at a minimum remove what might otherwise be a temptation for management in the form of legally permissible distributions. That benefit appears significant enough to tip the cost-benefit scales in the direction of the California provisions.

A legislature considering the California provisions can obtain greater benefits, or reduce costs, by making the following changes therein:

1. It appears that inclusion of a retained earnings test as an alternative to the remaining assets tests for the permissibility of making distributions not only complicates the statute’s operation, but also reduces the statute’s effectiveness in preventing financial distributions by financially troubled corporations. Thus, it seems reasonable to eliminate the retained earnings test.

2. It appears that the remaining assets tests may benefit from further empirical studies to determine which relationships and weights will optimize, with minimum costs, the long-run survival of corporations subject to the provisions.

Code § 500: Are Creditors Adequately Protected?, 16 U.C.D. L. Rev. 375, 390–408 (1983). Ben-Dror applied the California tests to 100 publicly held corporations that went bankrupt between 1970 and 1976. The tests would have prevented 37 of the corporations from making distributions for the year prior to bankruptcy, 25 of the corporations from making distributions the second year prior to bankruptcy, and 11 of the corporations from making distributions the third year prior to bankruptcy. Id. at 408.

449. For the 100 corporations studied, mean total assets (excluding intangible assets) exceeded mean total liabilities even in the year preceding bankruptcy. See Ben-Dror, supra note 448, at 393–95 & n.85.

450. This statement assumes that the fraudulent conveyance rules would not have applied to the distributions.

451. See supra note 225.

452. Ben-Dror states that application of the remaining assets test as the only test for distributions would have prohibited 68 of the 100 corporations from making distributions one year before bankruptcy. Ben-Dror, supra note 448, at 394. Applying either the retained earnings alternative or the remaining assets test, reduces the number to 57.

453. Ben-Dror suggests that the retained earnings test and the remaining assets test both be applied to determine whether a proposed distribution could be made. Ben-Dror, supra note 448, at 413. Such action would increase the number of financially troubled corporations prohibited from making distributions one year before bankruptcy to 77. See id. at 409. But such action would also increase the size of the control group of solvent corporations prohibited from making distributions. Id.

Using a retained earnings test brings with it all the accounting difficulties as to the calculation of that amount. See, e.g., supra text accompanying notes 84–85. Such costs appear to outweigh the rather minor increase in protection obtained by adopting the retained earnings test in addition to the remaining assets test. In any event, such added protection may be obtainable by changes in the asset ratios embodied in the remaining assets test.

454. Ben-Dror argues for “a more sophisticated model of bankruptcy prediction which, based on a diverse set of predictors, will take into account the industrial category of the corporation and evaluate business trends across several financial statements.” See Ben-Dror, supra note 448, at 413. Pre-
3. Assuming that some type or series of remaining assets tests are to be applied, such tests should be applied, as in California, as general limits on distributions by large and small corporations. However, it appears that the legislature should then address the special problems of financial distributions by the latter type of corporation, which tend to be almost exclusively related to installment repurchases of shares. The California determination to test such transactions generally as cash or property paid by the corporation to the former shareholder generally facilitates entry into such transactions, while affording adequate protection to creditors. But such testing also operates to present significant continuing risks to the selling shareholder, which may bulk so large when a change of control is involved as to prevent an otherwise meritorious transaction. To prevent such problems, the statute should contain a broader elective process by which a selling shareholder can be assured that the statute’s tests will be applied only at the time of entry into the transaction, and therefore that the debt incurred by the corporation will thereafter be on a parity with debt to third parties. Such election should be available only to small corporations.

4. It appears that the legislature should also consider the special problems of distributions by publicly held corporations.

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456. See supra text accompanying notes 263-69. Such risks are quite substantial in connection with bootstrap acquisitions of the corporation’s stock by third parties.
457. The sole election in CAL. CORP. CODE § 166 (West 1977 & Supp. 1983) comes about by the application of the tests at the outset if a negotiable debt security is issued on the repurchase. Issuance of such securities does not seem to be an option for a small corporation.
458. The difficulty with the California resolution of the matter is that the tests are applied as each installment is paid even though the entire transaction, if tested at the outset, could have easily met the statute’s tests. It can be argued, of course, that complete outset testing under any circumstances deprives creditors of the equitable insolvency cut-off in the California statute. My sense of the way to deal with that problem is to impose stricter standards to installment repurchases for which outset treatment is elected than are generally applied to cash or property distributions. I would combine that approach with a required public filing before the closing of the transaction that indicates that the corporation meets the stricter standards and proposes to make the repurchase. Such an approach would probably reduce the number of bootstrap acquisitions of shares, or at least broaden the width of the strap. Neither effect is undesirable.
459. As is noted below, none of the special reasons for facilitating installment repurchases arises in the case of publicly held corporations.
460. For simplicity, I would define publicly held corporations as those corporations required to register shares with the SEC under section 12(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 78l(g) (1982).

While there is no United States precedent for different financial provisions for publicly held corpo-
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It appears that shareholders of a publicly held corporation need the additional protection of notice from the corporation whenever such distributions for the twelve-month period ending with the current distribution exceed its earnings for such period. Payment of such dividends indicates either that management believes that future earnings prospects are significantly better than recent earnings, or that management is attempting to obfuscate recent poor earnings performance. In either event, notice to shareholders should be beneficial, since it is likely to be accompanied by management’s explanation of the distribution pattern. In the case of share repurchases by publicly held corporations, there appears to be no reason not to test repurchases by issuance of corporate debt at the time of the issuance of such debt. Repurchases for cash, property, or debt that are in excess of current annual earnings should again trigger a requirement of notice to shareholders.

These changes, combined with alternatives noted in the analysis of the California provisions, should produce a favorable benefit-to-cost relationship for the resulting provisions.

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461. Debate has recently been joined regarding the value and feasibility of disclosures by management when changes are made in corporate dividend policy. See Brudney, supra note 13 (arguing that management be required to disclose when dividend signals are contrary to management’s beliefs regarding corporate prospects); Fischel, supra note 13 (arguing that Brudney exaggerates the benefits of such disclosure while underestimating its cost).

As is implied in text, it appears to me that Professor Brudney has the better part of the argument with Professor Fischel.

462. See discussion of reasons for repurchases by publicly held corporations in Kummert, supra note 10, at 381–91.

463. See supra notes 206–43.