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# STATUTORY LIMITS ON A CORPORATION'S RIGHT TO MAKE DISTRIBUTIONS TO SHAREHOLDERS: THE LAW OF DISTRIBUTION IN THE 1984 REVISED MODEL BUSINESS CORPORATION ACT

by

PHILIP MCGOUGH\*

Corporations make distributions of cash and other property to shareholders through dividends or repurchases of stock. In common law, there are limits on the amount of assets that can be distributed to owners. The accounting model itself — assets minus liabilities equal owners' equity — implies the basic common law limit on distributions to shareholders: if creditors' claims on assets have priority over those of owners, assets at least equal to the value of creditors' claims must remain in the corporation. State business corporation laws, of course, have always upheld this basic limit. But most states, following the earliest English corporate charters, began early to supplement it, to provide additional statutory limitations on the amount that could be distributed to the owners of a business.<sup>1</sup>

The Model Business Corporation Act (MBCA), is no exception. Since 1950, the American Bar Association has provided for the states a Model Business Corporation Act.<sup>2</sup> This carefully worked out formulation of a state business corporation act, based on the Illinois Business Corporation Act of 1933, was to provide state legislators with a guide for drafting legislation to regulate the internal affairs of business corporations.<sup>3</sup> It has been enormously influential. Over the course of over thirty years, it was directly adopted, at least in part, by thirty-five states and has had some impact on several others.<sup>4</sup>

Over the years, the American Bar Association has made numerous piecemeal revisions to the originally formulated model act, including a 1969 revision of the act itself, but it was only in 1984 that a complete structural revision of the original Model Business Corporation Act was made.<sup>5</sup> While the

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<sup>1</sup>For a history of early restrictions on dividends, see Kehl, *The Origin and Early Development of American Dividend Law*, 53 HARV. L. REV. 36 (1939).

<sup>2</sup>MODEL BUSINESS CORP. ACT (revised), 6 BUS. LAW. 9 (1950). An initial draft appeared in 1946 as a Report to the Section of Corporation, Banking and Mercantile Law of the American Bar Association.

<sup>3</sup>For a discussion of the origin and purpose of the Model Act by its chief author, see Garrett, *History, Purpose, and Summary of the Model Business Corporation Act*, 6 BUS. LAW. 1 (1950).

<sup>4</sup>Committee on Corporate Law of the Section of Corporation, Banking, and Business Law, American Bar Association, MODEL BUSINESS CORPORATION ACT ANNOTATED, 3rd ed., vol. 1, xxiv (1985 and Supp. 1986).

<sup>5</sup>*Id.*, 4 vols. The law of distribution incorporated into the 1984 Model Act was first adopted as amendments to the Model Act. The proposed amendments were published in 34 BUS. LAW. 1867 (1979) as *Changes in the Model Business Corporation Act — Amendments to Financial Provisions: A Report of Committee on Corporate Laws*. The proposed amendments were adopted by the Committee on December 8, 1979 as reported in 35 BUS. LAW. 1365 (1980). For a history of the development of the 1984 Model Act, see Goldstein and

1984 MBCA has made many substantial changes throughout the original model act, it has completely reformulated the provisions governing corporate distributions to shareholders. The purpose of this paper is to review the law of distribution in the 1984 Model Business Corporation Act. As we shall see, the 1950 MBCA's basic stance was that distributions should be made from earnings and that any distribution from contributed capital should require notification and approval of shareholders. The 1984 MBCA rejects the original stance and provides for minimal restrictions on distributions. What follows is in two parts: the first is a general survey of the law of distribution, the second compares the 1950 and 1984 versions of the MBCA in how they regulate distributions to shareholders.

## THE LAW OF DISTRIBUTION

### *What Is It and Why Is It?*

By definition a distribution is almost any transaction of a corporation with its own shareholders which reduces owners' equity. A corporation usually makes distributions to shareholders through dividends, purchases of its own outstanding shares, and stock redemptions. In unusual cases, a corporation makes distributions in the event of a partial or complete liquidation. Since corporations are ongoing and liquidations are an extraordinary event, dividends are the ordinary vehicle of a corporate distribution. The U.S. Department of Commerce estimates that U.S. domestic business corporations paid out almost 70 billion dollars in dividends in 1985.<sup>6</sup> Originally illegal in this country, treasury stock transactions have become another important form of distribution for United States corporations especially in the last twenty years. One estimate for domestic non-financial corporations has stock repurchases and retirements for 1986 at close to 50 billion dollars.<sup>7</sup> In the U.S., the law of distribution in the states' business corporation acts regulates when corporations may make distributions to shareholders and establishes liability in the event of an illegal distribution.<sup>8</sup>

Why should the state regulate distributions to shareholders? The question is a specific form of the general question, why should the state regulate the internal affairs of the corporation? The short, standard answer to both is the same: as a matter of public policy and to balance the competing interests of

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Hamilton, *The Revised Model Business Corporation Act*, 38 BUS. LAW. 1019 (1983). The 1950 Model Business Corporation Act had been amended on numerous instances and in 1969 a revision of the act was published MODEL BUSINESS CORP. ACT: REVISED 1969, Committee on Corporate Laws of the American Bar Association (1969). The 1984 MODEL BUSINESS CORPORATION ACT, however, is the first complete structural revision of the 1950 act.

<sup>6</sup>U.S. Department of Commerce, 66 SURVEY OF CURRENT BUSINESS 9 (July 1986) Table 8.7, 86.

<sup>7</sup>*Salomon Brother's Annual Report Forecasts a Credit Slowdown in 1986*, PR Newswire (12/18/85) 103.

<sup>8</sup>For a comprehensive study of statutory restrictions on distributions, see Kummert, *State Statutory Restrictions on Financial Distributions by Corporations to Shareholders* (pts. 1 & 2), 55 WASH. L. REV. 359 (1980), 59 WASH. L. REV. 185 (1984).

those involved: managers, creditors, stockholders, potential stockholders, and potential creditors. These various divergent interests have received varying degrees of emphasis in the law of distribution. Historically, the primary purpose of the law has been to protect the interests of creditors, i.e., to safeguard their specific interest in assets, and often to provide additional protection against the risk of corporate insolvency. But in addition to protecting the creditors, restrictions on distribution developed to protect different classes of shareholders among themselves, and, perhaps just as significant, as a statutory requirement that in corporations as a matter of policy, contributed capital, or some portion of it, remain unavailable for general distribution.

### *Approaches to Regulation*

While the specific restrictions on distributions in state statutes vary considerably, and the terminology employed varies even more so, in effect there have been only four general approaches taken in the statutory regulation of distributions:

1. the minimal approach — prohibiting any distributions from an insolvent corporation or distributions that would make the corporation insolvent
2. the traditional approach — restricting distributions to earnings
3. a 20th century U.S. approach — restricting distributions to earnings and some portion of contributed capital
4. the California approach — restricting distributions on the basis of financial tests.

#### 1. *To restrict distributions according to the standard of insolvency*

The nature of the corporation dictates that the claims of creditors on assets are prior to those of owners. It follows that assets cannot be distributed to owners in violation of the rights of creditors. Bayless Manning in *A Concise Textbook on Legal Capital* writes:

If the hierarchical relationship of creditor to shareholder is to have any meaning at all, then the management must not be left to shovel all the assets in the corporate treasury out to the shareholders when the corporation has insufficient assets to pay its creditors or when the shareholder distribution itself renders the corporation unable to pay its creditors.<sup>9</sup>

A basic and minimal approach to the law of distribution then is the test of insolvency: if a corporation cannot meet the demands of creditors, either in the short or long run, it is unlawful to make distributions to owners.

Even in a state without a statutory insolvency test, a distribution made

when a corporation was insolvent or one which rendered the corporation insolvent, would probably be unlawful. As the authors of one leading casebook on the law of corporations put it, "The payment of a dividend when a corporation is insolvent may also be illegal as a matter of common law, either on the theory of common law fraudulent conveyance, or the theory that the assets of an insolvent corporation are a trust fund for the creditors."<sup>10</sup> In other words, a statute regulating distributions by the test of insolvency is probably not imposing any new legal restrictions on a corporation, but merely codifying existing ones.<sup>11</sup>

## 2. *To restrict distributions to earnings*

In fact, the charters of the earliest English corporations restricted shareholders dividends to earnings. These early charters protected contributed capital, and allowed distributions only from that portion of capital based on earnings. According to Donald Kehl,

With the general acceptance prior to 1700 of permanent capital by English companies, there came also the genesis of dividend regulation. The necessity for differentiating capital from income [contributed capital from earned capital] had arrived. In the future, enterprises must be managed so as to preserve for stockholders the capital investment from which over the years annual profits were to flow.<sup>12</sup> (parenthetical added)

In fact this could be done in either of two ways: prohibiting distributions from contributed capital or restricting distribution to earned capital. For example, in 1620, the charter given by James I to the New River Company restricted dividends to earnings.<sup>13</sup> The backward approach is not to limit dividends to earnings, but to forbid distributions from contributed capital. An early example of this occurred in 1697 when Parliament authorized an increase in the Bank of England's capital, and expressly provided that shareholders who were paid dividends out of [contributed] capital would be liable to the Bank's creditors to the extent of the dividends received.<sup>14</sup> Theoretically, since an income statement connects two balance sheets, whether the approach is framed in terms of the balance sheet or the income statement, the result should be the same. Since accounting is not an exact science, the result, in fact, is not always the same.

<sup>10</sup>WILLIAM CARY and MELVIN EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1340 n.1 (5th ed. 1980).

<sup>11</sup>Insolvency can have two distinct meanings in law, the equity and bankruptcy senses. Solvency in the bankruptcy sense looks to liquidation: if all assets were sold would there be sufficient money for the claims of creditors. Solvency in the equity sense assumes an ongoing business being able to pay debts as they become due. It is solvency in the equity sense — an ongoing business being able to pay debts as they come due — that is generally used by states and is used in the 1950 and 1984 MBCA's, to limit distributions to shareholders. See Manning, *supra* note 9, at 60.

<sup>12</sup>See DONALD KEHL, CORPORATE DIVIDENDS 4 (1941).

<sup>13</sup>*Id.*

<sup>14</sup>*Id.*  
<http://ideaexchange.uakron.edu/akronlawreview/vol21/iss1/2>

### 3. *To restrict distributions to earnings and some portion of contributed capital*

Of the first three traditional approaches to distribution, this was the last to develop. Kehl attributes its development to two facts: the more stable economic environment of the twentieth century, and competition among the states to attract corporations.<sup>15</sup> If corporations are not in danger of bankruptcy, protection of creditors is not as grave a concern and there is no compelling reason to require that all contributed capital be retained in the corporation. Furthermore, if states are competing to attract corporations, one tactic is to liberalize the state's business corporation laws. A liberalization of the basic restrictions on distributions can be part of this process. In fact, this liberalization often took the approach of requiring corporations to distinguish between stated and surplus capital, stated capital being simply a portion of contributed capital often arbitrarily selected by the managers of a corporation, surplus being the rest. It was this stated capital, simply a portion of contributed capital, that was not available for distribution. Ohio's General Corporation Act in 1927, which had a far-reaching influence, limited dividends to "surplus of the aggregate of its assets over the aggregate of its liabilities, plus stated capital."<sup>16</sup>

This approach to distribution restriction is essentially a compromise between the insolvency approach, which allows a distribution of everything but the specific claims of creditors, and the earned capital approach, which retains all contributed capital. This compromise approach has been called "the trust fund doctrine":

. . . a corporation must establish a legal capital in connection with the issue of its shares and must retain that amount as a margin of assets over liabilities before making distributions to shareholders.<sup>17</sup>

This "margin of assets over liabilities" becomes a trust fund. Of course, as the amount of contributed capital protected becomes smaller and smaller, this restriction approaches the insolvency restriction which requires only the protection of specific claims of creditors.

### 4. *Restriction based on financial tests*

#### *Current Earnings*

If a distribution is allowed from current earnings, the restriction is really being based on the current operating performance of the business. A business with a history of loss may have a successful current period, and a distribution allowed out of current earnings will in effect be from contributed capital. The distribution is allowed because the criterion is a financial test: earnings in the

<sup>15</sup>*Id.* at 17.

<sup>16</sup>Ohio Laws 1927, at 35, *quoted in* Hackney, *supra* note 31, at 1360-61.

<sup>17</sup>Ballantine and Hills, *Corporate Capital and Restrictions upon Dividends under Modern Corporation Law*, 23 CALIF. L. REV. 229, 230 (1935).

current period. It emphasizes short-run performance, and ignores the relationship of short-run performance to contributed and earned capital. This financial test has been used by various states in their state business corporation laws and was added to the original 1950 MBCA as an alternative reading in 1965.<sup>18</sup>

### *The California Approach*

The 1977 California General Corporation Law is remarkable in that it attempts to regulate distributions according to more sophisticated financial tests.<sup>19</sup> The statute begins with a traditional test of insolvency: it prohibits distributions if the corporation is insolvent in the equity sense (an ongoing business' ability to pay debts) or would be likely to be rendered so by the distribution. But it does not stop there. The California statute restricts distributions to earned capital unless two tests are both met, in which case a distribution can be made from contributed capital. The first test is for the protection of all creditors and requires that "the sum of the assets of the corporation (exclusive of goodwill, capitalized research and development expense and deferred charges) would be at least equal to 1¼ times its liabilities (not including deferred taxes, deferred income, and other deferred credits) . . ."<sup>20</sup> The second test, for the protection of current creditors, is a fairly sophisticated measure of liquidity: "The current assets of the corporation would be at least equal to its current liabilities or, if the average of the earnings of the corporation before taxes on income and before interest expense for the two preceding fiscal years was less than the average of the interest expense of the corporation for such fiscal years, at least equal to 1¼ times its current liabilities . . ."<sup>21</sup>

This is not the place to comment on these tests.<sup>22</sup> Suffice it to say, it marks a new approach to an old problem, using financial tests such as might be employed by a bank or other financial institution in the statutory regulation of distributions.

### THE MODEL BUSINESS CORPORATION ACTS: 1950 AND 1984

The 1950 and 1984 Model Business Corporation Acts provide quite different solutions to the problem of statutory regulation of distributions. The following analysis compares the two acts with respect to: a) general approach, b) conceptual framework, c) directors' liability, and d) generally accepted accounting principles.

<sup>18</sup>See discussion in Manning, *supra* note 9 and 11, at 76-77.

<sup>19</sup>Act of September 12, 1975, ch. 682, 1975 Cal. Stat. 1514. See CAL. CORP. CODE § 500-11 (West 1977 & Supp. 1986).

<sup>20</sup>CAL. CORP. CODE § 500.

<sup>21</sup>*Id.*

<sup>22</sup>See Ben-Dror, *An Empirical Study of Distribution Rules Under California Corporations Code § 500: Are Creditors Adequately Protected?*, 16 U.C.D.L. Rev. 375 (1983).

### *1950 MBCA: General Approach*

As outlined above, there are four general approaches to the law of distribution — a statute can restrict distributions on the basis of insolvency; can restrict distributions to earnings; can restrict distributions to earnings and some portion of contributed capital, and can restrict on the basis of various financial tests. The 1950 Model Act made a combination of the first (insolvency) and second (earnings) methods. First, the 1950 Model Act incorporated a restriction based on insolvency, and then went further in tending to restrict distributions to earned capital.<sup>23</sup>

While it was not verbalized, the philosophy of distribution implied in the provisions of the 1950 MBCA was that capital contributed by shareholders was to be retained in the corporation, that the proper source for distributions was earnings. When and if contributed capital was to be distributed, there should be notification and approval of shareholders.

Kehl, in his book on dividend distribution, which was published five years before the first (1946) draft version of the MBCA, wrote the following:

A . . . purpose in dividend regulation, sometimes neglected by overemphasis on protection of creditors, is that of assuring continuous maintenance of capital in order that the enterprise may function for the purposes contemplated by stockholders. . . . The purpose of the stockholder is a capital investment, and although he expects dividends, he expects them from profits. When they are paid from capital, it should be an exceptional distribution which he has authorized.<sup>24</sup>

This quotation could be used to describe the approach of the 1950 MBCA.

Although the 1950 Act did not specifically prohibit distributions from contributed capital, it contained restrictions to prevent its erosion. Distributions could be made from contributed capital if the corporation remained solvent, but only if certain conditions were met. A board of directors that wished to make a distribution out of contributed capital could do so only if the by-laws of the corporation provided or if they had two-thirds vote of shares, and the distribution had to be labeled a partial liquidation.<sup>25</sup> Clearly this provision was not so much for the protection of creditors as for the protection of the stockholders themselves, the stockholders as consumers. If the stockholders are to receive distributions from contributed capital, they must know the source. In general, this is a restrictive approach to the law of distribution.

### *1984 MBCA: General Approach*

The general approach of the 1984 MBCA is a minimal restriction on

<sup>23</sup>In the 1950 MBCA, the law of distribution was found chiefly in sections 2, 5, 40, 41, and 43. MODEL BUSINESS CORP. ACT, *supra* note 2.

<sup>24</sup>Kehl, *supra* note 12, at 18.

<sup>25</sup>MODEL BUSINESS CORP. ACT *supra* note 2, at § 41.

distributions. It reflects a different, less active role for a state's statute to play in regulating corporations. In fact, the Model Statute as revised combines the first general approach, an insolvency test, with the third, restricting distributions to earnings and a portion of contributed capital. However, the portion of contributed capital protected, not available for distribution, is the absolute minimum, equal to only the preferred liquidation rights of senior shareholders.<sup>26</sup> In effect, virtually all of contributed capital is available for distribution. This is a fundamentally different approach to the law of distribution than was contained in the original Model Business Corporation Act.

The drafters of the 1979 amendments which were incorporated into the 1984 Model Statute Act wrote in their general comment:

In the Model Act as in effect prior to the amendments, dividends and stock repurchases could not lawfully be made by a corporation if, after giving effect thereto, the corporation would be insolvent in the equity sense, i.e., unable to pay its obligations as they become due in the ordinary course of business. The Committee [drafting the amendments] concluded that this is the fundamentally important test. . . .<sup>27</sup>

The drafters do not mention that the 1950 Model Act went considerably beyond the insolvency test. Having decided that insolvency is the "fundamentally important test" for distributions, the drafters have eliminated virtually all the protections on contributed capital found in the 1950 Act. In fact, except for the creditor-like preferred liquidation rights of senior shareholders, the only restriction on distributions is insolvency.

As noted earlier, the insolvency standard is a minimal one, and a distribution made when a corporation is already insolvent or would be rendered so by the distribution is very likely illegal regardless of the controlling business corporation statute. The claims of creditors on assets always have priority over those of owners.

The general approach of the amended statute then is to restrict corporate distributions as little as possible and to leave as much as possible to the discretion of corporate managers. The underlying philosophy of the new amendments seems to be one of *laissez faire*. The statute sets out only the most minimal legal protection for creditors and leaves the rest to the business judgment of those who manage corporations.

### *1950 MBCA: Conceptual Framework*

In the 1950 Model Act there was no single law of distribution. Separate sections established restrictions on four different kinds of distribution: stock reacquisitions, dividends, partial liquidations, and stock redemptions. Whatever the form of a distribution, restrictions were framed in accounting

<sup>26</sup>Committee on Corporate Laws, *supra* note 4, at § 6.40.

<sup>27</sup>Changes in the Model Business Corporation Act, *supra* note 5, at 1868.

terminology: net assets, stated capital, surplus, earned surplus, and capital surplus. The structure of restriction began with net assets: "the amount by which the total assets of a corporation . . . exceed the total debts of the corporation."<sup>28</sup> Next came "stated capital," roughly an amount equal to the par or stated value of the shares.<sup>29</sup> Surplus was "the excess of the net assets of a corporation over its stated capital."<sup>30</sup> Surplus was then divided into two parts, capital and earned. Since normally distributions would only be allowed from the earned portion of total surplus, the cornerstone in the structure of restriction was earned surplus. A special committee approached the problem of defining earned surplus and followed very closely a definition prepared by the accounting profession at that time.<sup>31</sup>

Earned surplus was defined as

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.<sup>32</sup>

There were exceptions to the general rule. For example, if their articles of incorporation so provided, wasting assets corporations could pay dividends out of depletion reserves.<sup>33</sup> But unearned surplus was available for distributions only in specified circumstances. The normal source for distributions would be earned surplus.

Because of the conceptual framework, the distribution regulations in the 1950 statute were quite complex. Not only were there four different standards in separate sections, depending on the type of distribution, but the restrictions depended on a determination of earned surplus, which in turn depended on the measurement of income, the creation of reserves, the elimination of deficits, and capital readjustments. But the main thrust of the regulation was to make earning the normal source of distributions.

### *1984 MBCA: Conceptual Framework*

Essentially, the amended Model Business Corporation Act recognizes that corporations make distributions to owners and the Act must govern these dis-

<sup>28</sup>MODEL BUSINESS CORP. ACT, *supra* note 2, at § 2(i).

<sup>29</sup>*Id.* at § 2(j).

<sup>30</sup>*Id.* at § 2(k).

<sup>31</sup>Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 Harv. L. Rev. 1357, 1362 (1957).

<sup>32</sup>MODEL BUSINESS CORP. ACT, *supra* note 2, at § 2(j).

<sup>33</sup>*Id.* at § 40(b).

tributions whether they take the form of stock repurchases, dividends, or “otherwise.” It then formulates one standard around the central concept “distribution.”

According to the Model Act, “distribution” means a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness, by a corporation to or for the benefit of any of its shareholders in respect of any of its shares, whether by dividend or by purchase, redemption or other acquisition of its shares, or otherwise.<sup>34</sup> The Committee deliberately left the concept of distribution broad enough to cover any possible distribution-like action by corporations. The comments, add:

The term ‘indirect’ in the definition of ‘distribution’ is intended to include transactions like the repurchase of parent company shares by a subsidiary whose actions are controlled by the parent. It also is intended to include any other transaction in which the substance is clearly the same as a typical dividend or share repurchase, no matter how structured or labeled.<sup>35</sup>

The single definition means that all forms of distribution are treated in exactly the same manner, according to the same standards. The definition eliminates the accounting terminology used to frame the 1950 version of the MBCA: net assets, earned surplus, and capital surplus, are no longer part of the vocabulary of the Act. The concept of treasury stock is gone. When a corporation purchases back its own issued stock, it becomes authorized but unissued stock. The conceptual framework of the 1984 MBCA eliminates the entire structure of restriction that dominated the 1950 Model Act.

### *1950 MBCA: Generally Accepted Accounting Principles*

Should statute and court undertake to prescribe a corpus of accounting principles? Should legislatures and courts instead refer all questions to accountants’ own evolving common law — “generally accepted accounting principles?” Or just refer some questions, and if so, which ones?<sup>36</sup>

Accounting not only defines the terms used to describe a corporation, it also provides principles used to value a corporation. When we talk about the “assets” or “liabilities” of a corporation, we are using accounting terminology, and we can also use accounting guidelines and standards in valuing those same assets and liabilities. It follows that a business corporation statute may owe a double debt to accounting. It may use accounting terminology to describe what portion of assets are restricted, and it then may use accounting principles of valuation in measuring that restricted portion.

In the 1950 MBCA, the law of distribution was conceptualized in ac-

<sup>34</sup>Committee on Corporate Laws, *supra* note 4, at § 1.40 (3).

<sup>35</sup>*Id.* at § 1.40(3).

<sup>36</sup>Manning, *supra* note 9, at 61-2.

counting terms, but the statute was strangely mute on the weight to be given accounting valuation. The act gave no specific authority or weight to generally accepted accounting principles. And the drafters of the act did not even seem to have noticed the issue.

In 1950, when the Committee on Business Corporations of the American Bar Association published the Model Business Corporation Act its chairperson, Ray Garrett, provided an introductory essay. After describing the provisions dealing with distributions, he concluded:

These provisions as described may seem complex, but the Committee believes that they afford a new and modern approach to corporate law and accounting that will eliminate the confusion now existing in the courts and in the legal profession over accounting matters, and provide accountants with a much needed statutory guide.<sup>37</sup>

But the confusion was not eliminated. Almost thirty years ago, Hackney in his article on the financial provisions of the 1950 Model Business Corporation Act, pointed out the confusion inherent in a statute which used accounting terminology and yet gave no particular authority to accounting practice.<sup>38</sup> The statute did not even take a clear stand on the issue of fair valuation, which of course would not be permitted under generally accepted accounting principles.

### *1984 MBCA: Generally Accepted Accounting Principles*

In the 1984 MBCA, the Act specifically addresses the issue of valuation and the weight to be given generally accepted accounting principles. In fact, they are given no special weight, but are simply one piece of information to be used by the corporate managers. The Committee that drafted the amendments included the following comment:

Incorporating technical accounting terminology and specific accounting concepts into new section 45 [the chief section on the law of distribution] was rejected, principally because such terminology and concepts are constantly under review and subject to revision by the Financial Accounting Standards Board, the American Institute of Certified Public Accountants, the Securities and Exchange Commissions and others. The Committee concluded that the Model Act should leave such determinations and resolutions of accounting matters to the judgment of the board of directors, taking into account its right to rely upon professional or expert competence and its obligation to be reasonably informed as to pertinent standards of importance that bear upon the subject at issue.<sup>39</sup>

The practical implications of this approach could be great. Again, quoting the committee, whether a distribution may be made is "explicitly authorized to be

<sup>37</sup>Garrett, *supra* note 3, at 5.

<sup>38</sup>Hackney, *supra* note 31, at 1368-70.

<sup>39</sup>*Changes in the Model Business Corporation Act*, *supra* note 5, at 1884 (italics added).

determined on the basis of either financial statements prepared under accounting practices and principles that are reasonable in the circumstances, or, in the alternative, *a fair valuation or other method that is reasonable in the circumstances.*"<sup>40</sup> The explicit criterion for valuation incorporated into the statute is "reasonable under the circumstances." This gives, of course, the widest latitude possible to directors in their determination of the legality of a distribution.

### *1950 MBCA: Liability of Directors*

The 1950 MBCA statute provided that directors would be liable for any distribution made contrary to the restrictions of the statute. In common law, directors have generally only been liable for unlawful distributions, if they have not acted in good faith and with due cause.<sup>41</sup> Under the 1950 model statute, a director who assented to an illegal distribution would be liable even if he or she acted in good faith.

### *1984 MBCA: Liability of Directors*

The 1984 revised MBCA moves the Act back to the common law position. If the director conforms to general standards of conduct set up in the act, a director is not liable for a distribution contrary to the provisions of the act. That standard of care only requires that the director act:

1. in good faith;
2. with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
3. in a manner he reasonably believes to be in the best interests of the corporation.<sup>42</sup>

As stated in the official comment, the focus is "on the manner in which the director performs his duties, not the correctness of his decisions."<sup>43</sup>

## CONCLUSION

The 1950 and 1984 Model Business Corporation Acts provide states with two very different approaches to regulating distributions. While it was not articulated, the philosophy of distribution implied in the provisions of the 1950 MBCA was that capital contributed by shareholders was to be retained in the corporation and the proper source for distributions was earnings. When and if contributed capital was distributed, there should be notification and approval of shareholders. The general approach of the 1984 Act is one of minimal restrictions on distributions. The amount that cannot be distributed is the absolute minimum; any method of valuation is potentially available to a board of

<sup>40</sup>*Id.* at 1868 (italics added).

<sup>41</sup>Committee on Corporate Law, *supra* note 4, vol. 2 at 1024.

<sup>42</sup>*Id.* at 928-30 (§ 8.30(a)).

<sup>43</sup>*Id.* at 927.  
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directors, and to establish liability requires both a showing of an illegal distribution and bad faith on the part of the director.

Specifically, there are four main differences between the two versions:

1. The general thrust of the 1950 act was to restrict distributions to earnings. It did so by protecting contributed capital and by allowing distributions of contributed capital only in certain instances, generally requiring both notification and approval of shareholders. The 1984 statute provides minimal restrictions on distributions, protecting creditors (who are protected without the statute) and the creditor-like liquidation rights of preferred shareholders.

2. The statute in 1950 had no single law of distribution, but devoted separate sections to stock reacquisitions, dividends, partial liquidations, and stock redemptions; the 1984 statute organizes the law around the single concept of "distribution."

3. In the 1950 statute, directors were liable for an illegal distribution without a showing that they acted in bad faith. In the revised statute, directors are only liable for an illegal distribution if they acted in bad faith.

4. The 1950 statute conceptualized the law of distribution in terms of accounting terminology, and created a close, although inadequately defined, relationship between the statute and accounting. The 1984 act makes the law of distribution independent of accounting; accounting data are to be evaluated like any other information that corporate managers have about the corporation.

The approach to distribution in the revised Model Business Corporation Act is in strong contrast to the approach in the business corporation act passed by the California legislature in 1976. As described above, California's statute restricts distribution on the basis of fairly sophisticated financial tests. Both the 1984 MBCA and the California statute seem predicated on the assumption that traditional approaches to states' statutory restrictions on distributions are outmoded. The 1984 Model Business Corporation Act, however, withdraws and makes restrictions minimal. California, on the other hand, moves forward with a brand new approach based on financial analysis.

Is there any rationale for the direction of the 1984 MBCA? Most commentators believe that the complex structural provisions of the 1950 MBCA's law of distribution did not work.<sup>44</sup> The provisions which tended to restrict distributions to earnings had enough exceptions that corporations could make distributions out of contributed capital. Not only did they not work, but an argument can be made that the provisions were irrelevant. When we consider the elaborate construction of the Securities and Exchange Act, the individual states' blue sky laws, and the various remedies in fraud, it is not hard to argue

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<sup>44</sup>See Manning, *supra* note 9, at 69 and Kummert, *supra* note 8, pt.2 at 284.  
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that the competing interest of various groups — common shareholders, general creditors, corporate officers, employees and the public — are adequately protected independently of the state business corporation acts.

At this point, most of the states still basically follow the 1950 Model Business Corporation Act in regulating corporate distributions. As the states amend their state business corporation acts, or adopt new ones, they now have two different approaches they might follow: the approach of the 1984 MBCA or the 1976 California state business corporation act. Only time will determine which of the two approaches will prevail.

## APPENDIX

## SPECIFIC DIFFERENCES

The following charts the chief differences in distribution law between the 1950 and 1984 versions of the MBCA.

- | 1950   | 1984  |
|--|---|
| <p>1. Framed in terms of accounting terminology: closely following accounting definitions, the model statute uses “net assets,” “stated capital,” “surplus,” “earned surplus,” and “surplus capital” as a framework for the law of distribution.</p>   | <p>1. Uses a single term — “distribution” — as a framework for the law. Eliminates entirely the following terms from the MBCA: “treasury stock,” “net assets,” “stated capital,” “surplus,” “earned surplus,” and “capital surplus.”</p>  |
| <p>2. Distinguishes between treasury stock transactions, dividends, and partial liquidations; each is treated in a separate section (section 5, 40, and 41). Restrictions are different for each.</p>  | <p>2. “Distribution” is used to cover treasury stock transactions, dividends, partial liquidations, and any similar transactions. All are treated in one section (section 6.40). Restrictions for all three are the same.</p>   |
| <p>3. Restrictions on Distributions:<br/>(a) <i>Dividends</i><br/>Negative: not permitted if it would render the corporation insolvent, i.e., unable to pay debts as they become due.<br/>Affirmative: additional dividend distributions are generally restricted to earnings and not permitted from contributed capital.<br/>Exceptions: dividends out of depletion reserves, accrued cash dividends on</p> | <p>3. Restrictions on Distributions:<br/>Negative: insolvency; no distribution may be made if it would make the firm unable to pay debts as they become due.<br/>Affirmative: assets equal to the claim of creditors and (unless the corporate charter permits otherwise) the preferential claims of shareholders must be retained; all other contributed and/or earned capital may be distributed to shareholders.</p> |

cumulative preference shares out of capital surplus.

(b) *Partial Liquidations.*

Negative: not permitted if it would render the corporation insolvent, i.e., unable to pay debts as they become due.

Affirmative: assets equal to the preferential rights (liquidation and accumulated dividends) of preferred stockholders may not be distributed. In addition, a partial liquidation requires provision in the articles of incorporation or a two-thirds affirmative vote by the holders of outstanding shares of each class of stock; it also requires notification to the stockholders that the distribution is a partial liquidation.

(c) *Treasury Stock.* Such stock can be purchased out of earned surplus; with at least two-thirds of eligible shares in favor, it can be purchased out of capital surplus. (There are certain minor exceptions to these provisions, for example, a corporation's purchase of its own stock to eliminate fractional shares.)

4. Valuation: No comment on whether assets may be valued by methods not

4. Valuation: Not limited to generally accepted accounting principles.

generally accepted in accounting.

Section 6.40(d) explicitly states that directors are not restricted to valuation based on accounting principles but may use “a fair valuation or other method that is reasonable in the circumstances.”

5. Unlawful Distributions-Liability of Directors: Directors are liable who assent to a distribution contrary to the provision of the Act.

5. Unlawful Distributions-Liability of Directors: Directors who assent to a distribution contrary to the provisions of the Act are only liable if they have not complied with the standard provided in the Act (section 8.33) for the performance of the duties of directors. According to section 35 the directors, to be liable, would probably have to be shown to have acted without good faith and without the care that “an ordinarily prudent person in a like position would use under similar circumstances.”

6. Timing of the Validity of Distribution: Statute does not comment.

6. Timing of the Validity of Distribution: A distribution is valid either when indebtedness is incurred (in the case of a dividend) or when assets are transferred.

7. Redemption Related Debt: Statute does not comment.

7. Redemption Related Debt: Since the validity of the distribution is from the time the debt is incurred, the debt is not

- (automatically)  
subordinated to the debts  
of ordinary creditors.
8. Indirect Distribution:  
Statute does not comment.
8. Indirect Distribution: If a subsidiary whose actions are controlled by the parent purchases the parent company stock, it is a distribution which according to the statutory definition can be direct or indirect.
9. Stock Dividends and Splits: Statute does not comment.
9. Stock Dividends and Splits: Since there is no transfer of assets or incurrence of indebtedness, these are not distributions.
10. Conflict with Other Laws:  
Statute does not comment.
10. Conflict with Other Laws: An optional provision makes the model statute “supersede the applicability of any other statutes of this state with respect to the legality of distributions.”