

LEGAL CAPITAL AND THE MODEL BUSINESS CORPORATION ACT: AN ESSAY FOR BAYLESS MANNING

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APPRECIATION

Bayless Manning, now living in well-earned retirement in Boise, has been one of the most original thinkers and writers on American law of our time. His influence on corporation law in the United States can be favorably compared with that of Justice Story in the nineteenth century.

As a practicing lawyer, teacher, writer, lecturer, legislative drafter, director of publicly held companies in the United States and abroad, advisor to the New York Stock Exchange, and active member of The American Law Institute and of the American Bar Association's Committee on Corporate Laws, Bay Manning has had an unsurpassed influence on the evolution of the law of corporations in this country and elsewhere. His impact can be found in the legal capital provisions of the Model Business Corporation Act (MBCA), now enacted in whole or in part by over thirty states; in the MBCA's former director-conflicting-interest provisions,¹ for which he was the principal drafter; in The American Law Institute's *Principles of Corporate Governance*;² and in the overgrown field of appraisal rights, where his seminal article, published in 1962, is still the single most influential statement on that neglected subject.³

Descended from a chief justice of Kentucky and raised by a single mother in pre-World War II Washington, Bay graduated from Yale in 1942 at nineteen and immediately joined the U.S. Army Signal Corps. In remote locations like the island of Kauai, he helped to decrypt the supposedly unbreakable Japanese

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1. MODEL BUS. CORP. ACT §§ 8.60-8.63 (1984).

2. See generally AM. LAW INST., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* (1992).

3. See generally Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962).

“Purple” code. After the war, he graduated from Yale Law School (where he was editor in chief of the *Yale Law Journal*); clerked for Justice Reed on the Supreme Court; practiced law in Cleveland with Jones, Day, Reavis & Pogue; taught at Yale Law School; worked in the State Department;⁴ served for seven years as the transformative dean of Stanford Law School; then became president of the Council on Foreign Relations; and thereafter was a partner at Paul, Weiss, Rifkind, Wharton & Garrison. Although he has at one time or another spoken Japanese, Norwegian, Spanish, and Hawaiian,⁵ he generally writes in English. When Bay generously associated me in writing the third edition of *Legal Capital*, it took us a year of weekends laboring in his One Lexington Avenue apartment, punctuated only by brief meals and walks in Gramercy Park. That year was a midcareer postgraduate course in corporate law, accounting, finance, equity pleading, legislative drafting, legal history, and, especially, writing. Bay said his target audience was “a reasonably intelligent, English-speaking, fourteen-year-old.” He felt that if he could explain something to her, anyone would understand it. Bay avoids grand words when simpler ones will do. He never uses “myriad” or “plethora” instead of “many” or “a lot.” Bay does not need or want to show off in his writing. He draws a sharp distinction between polysyllabic Latinate words and terser Anglo-Saxon ones, and he has a clear preference for the latter. Although he writes with greater elegance than any lawyer I have known, it is the elegance of uncluttered clarity, focus, and brevity—like the writing of another great lawyer, Lincoln.

Because he has significantly influenced the practice, teaching, and writing of countless lawyers and teachers for more than sixty years; because he was the first to expose the intellectual emptiness of the nineteenth-century concepts of par value and stated capital and then created a new legal capital regime that is now widely accepted in the United States and increasingly elsewhere as well; and because I think he just might like it, this essay is for Bayless Manning.

I

THE EXPOSURE OF “LEGAL CAPITAL”

The MBCA followed faithfully from the early nineteenth-century emergence of par value, stated capital, surplus, and the later enactment of statutes employing those concepts to limit the corporation’s power to make payments to its shareholders on account of their stock. For the MBCA’s first

4. Where he once observed (at first to himself and later to this author), while on a brief ride during the Vietnam War from Foggy Bottom to the White House with the secretary and the undersecretary, that the only person in the car who actually knew where he was going was the driver.

5. Yes, Hawaiian. I encountered Bay by chance in Honolulu at an ABA annual meeting, and he offered that he knew a place that made the best mai-tais in the islands. When we arrived, he began speaking to the Polynesian-appearing bartender in a language I did not recognize. As we were each taking our first sip of a perfectly stratified mai-tai—still the best one I have ever had—I asked him, in English, what language he was speaking with the bartender. He replied, “Hawaiian”—a legacy of his wartime service.

thirty years, its distribution provisions contained both an equity solvency test and the traditional stated-capital or earned-surplus test.⁶ That is, a corporation could pay a dividend only if, after payment of the dividend, the corporation could pay its debts as they became due *and* the corporation's assets exceeded the sum of its liabilities and stated capital. This was the case even though stated capital was a nominal, arbitrary, and economically irrelevant number.

Bayless Manning first identified and revealed the vacuity of traditional legal capital statutes in the first two editions of his celebrated book, *Legal Capital*.⁷ Then, during the 1980s, he served on the American Bar Association's influential Committee on Corporate Laws, the author and continuing overseer of the MBCA. His three most important insights during this period were:

First, all pro rata payments to shareholders on account of their shares—whether by dividend, redemption, other reacquisition, or partial liquidation—have the same economic effect on the corporation (a decrease in its assets, typically cash) and on the shareholders (no change in each shareholder's percentage of shares owned). Therefore, there should be no difference in their legal treatment. Even a non-pro rata share acquisition by the corporation offers no more opportunity for board misbehavior than issuing shares in exchange for a parcel of land or a computer-software program of uncertain value.⁸

Second, it makes no economic sense to base, even in part, the amount of assets that a corporation has the power to distribute on arbitrary and economically irrelevant figures like par value and its derivative, stated capital.⁹

Third, there is no difference between “treasury shares”—shares that the corporation issues but later reacquires (whether through redemption or repurchase)—and shares that are authorized but never issued. Therefore, treasury shares serve no conceptual purpose and should be abolished.¹⁰

As a result of Bay's pioneering work, the MBCA's financial provisions were completely overhauled, beginning with amendments in 1980 and continuing with the 1984 revision.¹¹ The new provisions jettisoned the old capital and

6. MODEL BUS. CORP. ACT §§ 45–46 (1969) (amended 1980).

7. *See generally* BAYLESS MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL (2d ed. 1981); BAYLESS MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL (1st ed. 1977).

8. *See* BAYLESS MANNING WITH JAMES J. HANKS, JR., LEGAL CAPITAL 12–16 (3d ed. 1990) (discussing payouts to shareholders).

9. *See id.* at 92 (“A corporation's ‘legal capital’ is a wholly arbitrary number, unrelated in any way to any economic facts that are relevant to a creditor. . . . [F]rom his standpoint the stated capital is simply a fortuitously-derived number that could as well have been taken from a telephone directory as from a series of unconnected and irrelevant historical events.”).

10. *See id.* at 190–92 (“[T]he concept of ‘treasury shares’ was a makeshift ameliorant to the artificial paralysis of ‘par,’ offering a way to permit shares to be sold at their market value. . . . [F]orgivable or not at the time of their inception, ‘treasury shares’ are today simply humbug.”).

11. *Compare* MODEL BUS. CORP. ACT §§ 6, 45–46, 66–70 (1969) (providing stated capital and capital surplus tests for distributions to shareholders), *with* MODEL BUS. CORP. ACT § 6.40 (1984) (providing the “equity solvency” and “balance sheet solvency” tests for distributions to shareholders). *See generally* Comm. on Corporate Laws, *Changes in the Model Business Corporation Act*—

surplus tests for distributions, as well as any apparition of par value or stated capital. In lieu, new section 6.40 substituted two tests for measuring a corporation's power to make a distribution.¹² Section 6.40(c), still unamended after more than twenty-five years, prohibits a corporation from making a distribution if, after giving it effect

(1) the corporation would not be able to pay its debts as they become due in the usual course of business [the so-called "equity solvency" test]; or

(2) the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution [the so-called "balance sheet solvency" test].¹³

The corporation must satisfy both of these tests. Note also that it must do so (1) at the time the distribution is authorized (except in the cases of a distribution of corporate indebtedness or a dividend paid after 120 days)¹⁴ and (2) after giving effect to the distribution, that is, assuming the distributed cash (or other assets) or corporate debt has been transferred to the shareholders.¹⁵

In addition, and significantly, section 6.40(d) permits a board of directors to determine that a distribution is not prohibited under subsection (c) based "either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances."¹⁶ This concept was formerly known as "revaluation surplus," that is, surplus created by restating the balance sheet on a fair-market-value basis. In Delaware, which to this day still has a modified old-style liabilities-plus-stated-capital statute,¹⁷ the concept of revaluation surplus has been adopted by case law.¹⁸

Amendments to Financial Provisions, 34 BUS. LAW. 1867 (1979) (presenting and discussing changes to the MBCA's financial provisions).

12. MODEL BUS. CORP. ACT § 6.40(c) (1984). The MBCA defines a "distribution" as 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 its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise.

Id. § 1.40. Thus, fundamental to the MBCA's unitary treatment of distributions is the recognition that the economic effect of a transfer of cash or other assets, or the incurrence of debt by the corporation to or for the benefit of the shareholders, has the same economic effect on the corporation and on its shareholders, no matter what the form of payment is or what it is called.

13. MODEL BUS. CORP. ACT § 6.40(c) (2008).

14. *Id.* § 6.40(e).

15. *Id.* § 6.40(c).

16. *Id.* § 6.40(d).

17. DEL. CODE ANN. tit. 8, § 170 (2009); see MANNING & HANKS, *supra* note 8, at 82–84 (discussing Delaware's "nimble dividend" provision).

18. See *Morris v. Standard Gas & Elec.*, 63 A.2d 577, 581–82, 585 (Del. Ch. 1949) (holding that directors of a Delaware corporation are under a duty to evaluate the assets on the basis of acceptable

Note too that the balance sheet solvency test treats as liabilities liquidation preferences of shares of stock that are senior on liquidation to the shares on which the distribution is proposed to be paid *unless* the charter specifically provides otherwise. Whether to include such an opt-out in the terms of preferred stock is always an important—and sometimes overlooked—economic issue for the corporation, prospective investors, and their counsel to consider. On the one hand, investors and their counsel, when negotiating the purchase terms of preferred stock, may be disinclined to agree to an opt-out, preferring to have their senior liquidation preference treated as a liability. This would result in an additional dollar-for-dollar block on the corporation's power to make distributions to the common and other junior stockholders, thus increasing the underlying cushion of assets available for dividend (and, potentially, liquidation-preference) payments to the preferred shareholders (and for debt repayment to creditors). However, the preferred-share investors also have an interest in the corporation's ability to raise additional common and other junior equity, which will further support the corporation's ability to pay the preferred dividends and, if necessary, the liquidation preference. Increasing the corporation's power to pay dividends furthers this interest. Thus, potential preferred investors will often agree to the opt-out.

In addition, the 1980 amendments to the MBCA eliminated the concept of "treasury stock."¹⁹ Previously, issued and outstanding shares reacquired through redemption or negotiated purchase continued to be treated as issued shares even though they were no longer outstanding. These shares were known as "treasury shares" and were so denominated in the stockholders' equity section of the balance sheet with several different possible accounting treatments, some of them tied to the artificial concepts of par value and stated capital. Significantly, unless the charter specifically provided otherwise, treasury shares were (are, in those jurisdictions where they still exist) and always have been just as available for reissuance as authorized but never-issued shares. A person to whom the corporation issues shares is not likely to care, or even know, whether the shares were previously issued to and held by someone else, who later sold them back to the corporation.²⁰ In its 1980 amendments, the Committee on Corporate Laws wisely concluded that issued and outstanding shares acquired by the corporation should return to the status of authorized but unissued

data and by standards they are entitled to believe reasonably reflect present "values" and must be given "reasonable latitude" in this regard).

19. Compare MODEL BUS. CORP. ACT §§ 2(h), 67–68 (1969) (providing that redeemed shares are canceled and considered authorized but unissued shares, unless their reissue is prohibited by the articles of incorporation, and that other reacquired shares may be either canceled and considered authorized but unissued shares or held as treasury shares), with MODEL BUS. CORP. ACT § 6.31 (1984) (providing that all reacquired shares are considered authorized but unissued shares). See generally Comm. on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments to Financial Provisions*, 34 BUS. LAW. 1867 (1979) (presenting and discussing the changes to the MBCA's financial provisions).

20. MANNING & HANKS, *supra* note 8, at 190–92.

shares.²¹ Thus, the balance sheet for a corporation organized under the laws of an MBCA jurisdiction will not distinguish between (1) authorized and never-issued shares and (2) authorized, formerly issued, but now-reacquired shares.

Finally, any effective rule must have an effective remedy. Section 8.33(a) of the 1984 revision of the MBCA provides that

unless he complies with the applicable standards of conduct described in section 8.30, a director who votes for or assents to a distribution made in violation of this Act or the articles of incorporation is personally liable to the corporation for the amount of the distribution that exceeds what could have been distributed without violating this Act or the articles of incorporation.²²

Personal liability for directors who approve the distribution provides an incentive for directors to reject a noncompliant distribution. However, section 8.33 of the MBCA also provides that a director will not be liable if he or she complied with the standard of conduct set forth in section 8.30.²³ To aid compliance with section 8.30, the MBCA permits a director to rely on “officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;” and on “legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person’s professional or expert competence or (ii) as to which the particular person merits confidence.”²⁴ Thus, a distribution may fail to comply with either the equity solvency test or the balance sheet solvency test, or both, of section 6.40(c); yet the approving directors, if each of them acted in good faith, in a manner that he or she reasonably believed to be in the best interests of the corporation and with the requisite care, will escape liability.²⁵ The MBCA, Delaware, and Maryland all provide for a right of contribution from other assenting directors and from shareholders.²⁶

21. MODEL BUS. CORP. ACT § 6.31(a) (1984); see Comm. on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments to Financial Provisions*, 34 BUS. LAW. 1867, 1869 (1979) (discussing changes to section 6).

22. *Id.* § 8.33(a); see also DEL. CODE ANN. tit. 8, § 170 (2009); MD. CODE ANN., CORPS. & ASS’NS § 2-312(a) (West 2009) (providing essentially the same).

23. The MBCA currently provides that “[e]ach member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.” MODEL BUS. CORP. ACT § 8.30(a) (2008) (amended 2009). In addition, directors must “discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.” *Id.* § 8.30(b).

24. *Id.* § 8.30(f).

25. It is good practice to have the chief financial officer or other responsible financial officer execute and deliver to the directors a certificate, confirming that, after giving effect to the proposed distribution, (1) the corporation will be able to pay its debts in the usual course of business and (2) the corporation’s assets will exceed its liabilities. See JAMES J. HANKS, JR., MARYLAND CORPORATION LAW form 9(b)(i) (Supp. 2000).

26. MODEL BUS. CORP. ACT § 8.33(b) (2008); DEL. CODE ANN. tit. 8, § 174(b)–(c) (2009); MD. CODE ANN., CORPS. & ASS’NS § 2-312(b) (West 2009).

It should be noted, however, that a director's violation of section 8.33 may not be included in a charter provision exculpating directors from monetary liability to the corporation or shareholders.²⁷

II

SECTION 6.40 AT WORK

In its nearly thirty years as part of the MBCA, section 6.40 (together with section 8.33) has worked remarkably well.²⁸ The principal questions have tended to collect around whether the payment of cash in a merger is a "distribution" by the acquired corporation, as well as the interpretation and application of the two solvency tests that are the heart of the statute.

A. Payment of Consideration in a Cash-out Merger

The MBCA defines a "distribution" as "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 its shareholders in respect of any of its shares."²⁹ The paradigm of concern is a merger of a corporation (*T* for target) into another corporation (*P* for purchaser) or into or with a wholly-owned subsidiary of *P* (*P Sub*) in which *T*'s shareholders receive cash in exchange for their shares, and *P* winds up in control of *T*, either through absorption of *T*'s assets and liabilities or through *P*'s control of *P Sub* or *T*, depending, respectively, on whether a forward or reverse triangular merger is employed.

At least two courts—both United States Courts of Appeals—have confronted this issue and reached opposite results.³⁰ In both cases, *T* and *P* negotiated at arm's length and entered into a merger agreement calling for a reverse triangular merger, with *T*'s shareholders exchanging their shares in *T* for the right to receive cash and *P* receiving new *T* shares. Thus, *P* became the

27. MODEL BUS. CORP. ACT § 2.02(b)(4) (2008); *cf.* DEL. CODE ANN. tit. 8, § 102(b)(7) (2009). Unlike the MBCA or Delaware, Maryland does *not* have an exception for improper dividends. MD. CODE ANN., CORPS. & ASS'NS § 2-405.2 (West 2009). In addition, the Maryland charter-exculpation statute applies to both directors *and officers*. Charter-exculpation provisions have been applied by the courts without any surprising results. *See, e.g.,* Hayes v. Crown Cent. Petroleum Corp., 249 F. Supp. 2d 725, 733–34 (E.D. Va. 2002), *aff'd in part, rev'd in part*, 78 F. App'x 857 (4th Cir. 2003); Grill v. Hoblitzell, 771 F. Supp. 709, 712 (D. Md. 1991); *In re Walt Disney Derivative Litig.*, 906 A.2d 27 (Del. 2006) (after ten years of litigation); Malpiede v. Townson, 780 A.2d 1075, 1095–96 (Del. 2001). It is important to note that charter-exculpation provisions adopted under these state statutes only permit exculpation for violations of the law of the state of incorporation, not federal law or the law of another jurisdiction. For a history of charter-exculpation statutes, see James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1207–10 (1988).

28. In addition, several non-MBCA states have substantially adopted section 6.40. *E.g.,* COLO. REV. STAT. § 7-106-401 (2009); MD. CODE ANN., CORPS & ASS'NS § 2-311 (West 2009); NEV. REV. STAT. § 78.288 (2009).

29. MODEL BUS. CORP. ACT § 1.40(6) (2008).

30. *In re C-T of Va., Inc.*, 958 F.2d 606 (4th Cir. 1992); *In re Munford, Inc.*, 97 F.3d 456 (11th Cir. 1996).

new and sole shareholder of *T*; and in both cases, creditors, or the corporate debtor in bankruptcy acting on behalf of creditors, sought damages against the former *T* directors for violation of the state-law counterpart of section 8.33 of the MBCA.

In *In re C-T of Virginia, Inc.*, the United States Court of Appeals for the Fourth Circuit held that “[p]ayment of the merger consideration to C-T’s former shareholders simply does not fit within the plain language of [Virginia’s] definition” of distribution,³¹ which was identical to section 1.40(6). The court, in a finely nuanced opinion by Judge Wilkinson, reasoned that when C-T transferred the cash merger consideration, the recipients “were no longer the corporation’s—its’—shareholders, for their ownership interest had been lawfully canceled as of the effective time of the merger.”³² But while C-T’s shareholders’ shares were being canceled, the shareholders received, in exchange for those shares, the right to receive cash.³³ Just because the cash was not actually paid to them until some later time, for example, upon tender of their share certificates, does not mean they had not already received the right to receive the cash. This situation is precisely parallel to a board’s authorizing a dividend, the corporation’s later sending a check for the amount of the dividend, and the shareholder’s subsequently cashing the check. The validity of the board’s action is tested at the time of authorization (unless the dividend is paid more than 120 days after authorization, in which case it is tested at the date of payment),³⁴ not when the check is sent, received, or cashed. Thus, splitting hairs by focusing on the timing of events that substantively happen simultaneously is not a satisfactory rationale. Nor is it particularly helpful to state that “[a] corporate acquisition, structured as a merger, is simply a different animal from a distribution.”³⁵ In support of this zoological proposition, the court erroneously stated that “[d]istribution statutes . . . traditionally apply to situations in which the shareholders . . . retain their status as owners of the corporation.”³⁶ This, of course, overlooks those redemptions and negotiated share repurchases that completely extinguish all of the shareholder’s shares.

In *In re Munford, Inc.*, the United States Court of Appeals for the Eleventh Circuit held that Georgia’s distribution and share-repurchase statutes, which included a solvency test, applied to a cash-out, reverse triangular merger.³⁷ In affirming the district court’s denial of the defendant directors’ motion for summary judgment, the Court of Appeals stressed the approval of *T*’s directors to the merger and the provisions in the merger agreement for *P*’s pledge of “virtually all” of *T*’s assets as collateral for the loan that provided the cash paid

31. *C-T*, 958 F.2d at 610.

32. *Id.*

33. *Id.*

34. MODEL BUS. CORP. ACT § 6.40(e) (2008).

35. *C-T*, 958 F.2d at 611.

36. *Id.*

37. *In re Munford, Inc.*, 97 F.3d 456, 459–60 (11th Cir. 1996).

to *T*'s shareholders in the merger.³⁸ If the approval of the merger by *T*'s directors were a basis for applying state distribution statutes, however, every merger would be subject to them—a position that did not seem to bother the court in *Munford*,³⁹ but which the court in *C-T* rightly noted was neither contemplated historically by merger statutes⁴⁰ nor administratively applicable by *T*'s soon-to-be-replaced directors.⁴¹

Although the court reached the right result in *C-T*, its analysis was unnecessarily tortured; and in *Munford*, the court was wrong in claiming that “nothing in these statutes precludes” their application to a merger or share repurchase that would cause the corporation to become insolvent.⁴² The straightforward and correct analysis is that the MBCA’s definition of “distribution” refers to the “transfer” of assets by only one corporation (“a corporation”),⁴³ and that a merger is not an act that one corporation may undertake alone. The fact that a merger involves another party, acting independently and at arm’s length, is critical. Even if a corporation arranged a merger with another related party for no rational business purpose other than to transfer money or other assets (or incur indebtedness) to the shareholders without complying with the equity and balance sheet solvency tests, a court would be justified in holding that the transfer was by “a corporation to or for the benefit of *its* shareholders.”⁴⁴ Therefore, the transfer would qualify as a “distribution” subject to the equity and balance sheet solvency tests of section 6.40.⁴⁵

B. Interpretation and Application of the Equity Solvency Test

The equity solvency test of section 6.40(c)(1) is essentially a test of the corporation’s liquidity. There is ordinarily little difficulty in determining whether a corporation, even one in financial difficulty, is *currently* able to pay its debts in “the usual course of business.”⁴⁶ Generally, it either is or is not paying its debts on time. The difficulties arise in determining the corporation’s ability to pay its debts in the usual course at some unspecified time *in the future*. The further in the future is the time when the determination must be made, the

38. *Id.* at 459.

39. *Id.*

40. Neither was this position, the court might have added, contemplated by most merger jurisprudence and practice.

41. *C-T*, 958 F.2d at 612.

42. *Munford*, 97 F.3d at 460.

43. MODEL BUS. CORP. ACT § 1.40(6) (2008).

44. *Id.*

45. *Id.* § 6.40. This interpretation is consistent with the official comment to the definition of “distribution”: “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.” *Id.* § 1.40 cmt. 3.

46. *Id.* § 6.40(c)(1).

more difficult it is for the board to make the requisite determination at the time of its authorization. The official comment to section 6.40 recognizes this issue:

[I]n determining whether the equity insolvency test has been met, certain judgments or assumptions as to the future course of the corporation's business are customarily justified, absent clear evidence to the contrary. These include the likelihood that (a) 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 sufficient to satisfy its existing and reasonably anticipated obligations as they mature, and (b) 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.⁴⁷

In addition to future sales and possible debt refinancing, a board could also consider, in determining equity solvency, possible asset sales (including factoring receivables and sale-leasebacks), pricing trends, equity raises, discounted pre-payment of existing liabilities, and compromise of contingent liabilities.⁴⁸ As well, the directors would typically be expected to take account of the corporation's business strategy and business plan, its current and pro forma financial statements (including cash-flow statements), and its budgets and material risk elements.

Importantly, section 6.40(d) permits a board to base its solvency determination "either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances."⁴⁹ While this permission is generally viewed as significant to satisfying the balance sheet solvency test,⁵⁰ it clearly applies to the equity solvency test as well. Thus, if there is reason to believe that some liabilities may be discharged for less than the amount shown on the corporation's balance sheet, prepared according to generally accepted accounting principles (GAAP), that fact may be taken into account in determining equity solvency on the basis of a non-GAAP balance sheet. Conversely, if it is not likely that the full amounts of the accounts

47. *Id.* § 6.40 cmt. 2.

48. In *Paratransit Risk Retention Group Insurance Co. v. Kamins*, a suit by an insurer against an insured company, the trial court was told to determine whether the company was insolvent under Colorado's "equity insolvency test," based on section 6.40(c)(2). 160 P.3d 307, 314-18 (Colo. App. 2007). Whenever a corporation is no longer operating in the "regular course of business," the court explained, the trial court should look to the following federal bankruptcy-court factors in determining whether the corporation is generally not paying its debts as they become due: "(1) the number of debts unpaid each month compared to those that are paid; (2) the amount of the delinquency; (3) the materiality of the nonpayment; and (4) the nature of the debtor's conduct of its financial affairs." *Id.* at 316 (citing *In re Leek Corp.*, 52 B.R. 311 (Bankr. M.D. Fla. 1985); *In re Reed*, 11 B.R. 755 (Bankr. S.D.W. Va. 1981)). Note that, appropriately, the number of factors is fewer and their applicability narrower for a corporation not operating in the "regular course of business."

49. MODEL BUS. CORP. ACT § 6.40(d) (2008).

50. See *infra* text accompanying note 65. Perhaps one reason for this misconception is that section 6.40 is discussed in the official comment under the heading "Balance Sheet Test," including two subheadings "Generally Accepted Accounting Principles" and "Other Principles"—an oversight that should be corrected by giving the discussion of subsection (d) its own heading. See MODEL BUS. CORP. ACT § 6.40 cmt. 4 (2008).

receivable as shown on the most recent GAAP balance sheet are likely to be collected, that too should be reflected in a non-GAAP balance sheet.

In *In re Vista Eyecare*,⁵¹ the debtor in a bankruptcy proceeding objected to proof of a claim for the exercise of a \$900,000 put option on the basis that the claim was unenforceable under the Georgia counterpart to section 6.40⁵² because payment of the claim would have made the debtor unable to pay its debts as they came due in the regular course of business.⁵³ The bankruptcy court disallowed the claim, explaining that

[a]pplying the equity insolvency test requires directors to assess a company's future prospects and is necessarily subjective to a degree and hence a matter of judgment. . . . The words "would not be able to pay" in subsection (c)(1) of [Ga. Code Ann. §] 14-2-640 require a board of directors to determine the likelihood that future cash flow will be sufficient to pay debts when they come due Thus, relevant considerations include whether the enterprise can continue as a going concern and can maintain or replace financing necessary to pay debts as they come due. The time horizon to which a board of directors must look under this section may vary with the circumstances of the particular company, but that horizon extends at least through the date on which a company is obligated to make substantial payments on existing large obligations, particularly if that date will occur within one year of the date of the proposed distribution.⁵⁴

The court noted further that the fact that the company's current assets are less than its current liabilities—a common standard of liquidity (that is, equity solvency)—is not dispositive of insolvency; instead, the question is whether the debt could be refinanced when it comes due.⁵⁵

Likewise, in *Meeks v. PRN, Inc.*,⁵⁶ a case involving a private company (a franchisee), the district court granted the defendants' motion for summary judgment because the two directors (one of whom was the plaintiff) who authorized the stock-purchase contract had not made a sufficiently "formal" analysis of the company's cash flow.⁵⁷ Therefore, held the district court, the stock-purchase contract, which apparently provided for the company's purchase of at least some of the plaintiff's shares in the company, was illegal and unenforceable.⁵⁸ The United States Court of Appeals for the Ninth Circuit held, however, that under Oregon's distribution statute, based on section 6.40,

the determination that the company is solvent enough to make a distribution may be made on the basis of any method that is reasonable under the circumstances. In this case, the company was small and closely held, which tends to vitiate the necessity of a

51. *In re Vista Eyecare*, 283 B.R. 613 (Bankr. N.D. Ga. 2002).

52. GA. CODE ANN. § 14-2-640 (2009).

53. *Vista Eyecare*, 283 B.R. at 615–16, 620.

54. *Id.* at 622–23, 625.

55. *Id.* at 623.

56. *Meeks v. PRN, Inc.*, No. 92-37019, 1994 U.S. App. LEXIS 23768 (9th Cir. Aug. 30, 1994).

57. *Id.* at *1–3.

58. *Id.* at *3.

detailed, formal analysis. The board, moreover, was entitled to take into account the future prospects of the company, such as its ability to refinance current liabilities.⁵⁹

The court noted that a “\$300,000 line of credit promised by FSI [apparently the franchisor] would have covered all of [the company]’s liabilities at the time of the distribution. That fact alone may be sufficient to support a reasonable conclusion that [the company] would be able to pay its debts as they came due.”⁶⁰

Almost all board decisions—hiring a new CEO, starting a new product line, closing a plant, borrowing money—are to a large extent based on predictions, or at least expectations, of the future. Thus, determining a distribution’s effect on the corporation’s ability to pay its debts in the usual course of its future business is well within the accepted ambit of the directors’ business judgment. Section 6.40 leaves plenty of room for just the kind of decisions that directors are routinely expected and well equipped to make—prudential business judgments about what is in the corporation’s best interests, based on their experience and their understanding of the corporation and its circumstances. Even the existence of a significant future obligation that the corporation is currently unable to pay should not preclude a board’s determination that the corporation will be able to discharge the obligation when it becomes due, through refinancing, future profits, or otherwise, and that, therefore, the corporation currently satisfies the equity solvency test. In determining the effect of a *present* distribution on the corporation’s *future* ability to pay its debts in the usual course of business, the board should also be able to consider not only measures to increase liquidity through monetization of assets and reduction of liabilities, but also the possible enhanced ability of the corporation to raise additional equity, especially if the stock has an established yield.

Generally speaking, the further in the future is the time for determination of solvency, the greater the latitude that directors should be accorded in reaching a judgment on the corporation’s ability to pay its debts at that time. The determination of future solvency is simply a component of the board’s overall responsibility for financing the corporation, which in turn is part of its general responsibility to oversee the management of the corporation’s business and affairs.⁶¹ The board’s determination of solvency is, therefore, entitled to the same deference as any other routine exercise of the directors’ business judgment. Like all business decisions by the board, this determination must have some rational basis, even though the decision made on this basis may subsequently turn out to be wrong. As always, however, the requirement of some rational basis is not a high bar and does not require (or even permit, unless the presumption of the business judgment rule is overcome) a

59. *Id.* at *4 (citing Robert C. Art, *Corporate Shares and Distributions in a System Beyond Par: Financial Provisions of Oregon’s New Corporations Act*, 24 WILLAMETTE L. REV. 203, 249–50 (1988)).

60. *Id.* at *4–5.

61. See MODEL BUS. CORP. ACT § 8.01(b) (2008).

retrospective judicial assessment of whether, at the time of the determination, there was another determination that might have had a *more* rational basis.⁶²

Of course, in fulfilling her duty of care under section 8.30(b) of the MBCA or under applicable case law, a director must become informed and should participate in the board's deliberations. In particular, a distribution's effect on the corporation's solvency at some future time is a matter about which many directors—even financially sophisticated ones—will want information and advice from the corporation's chief financial officer and financial advisors, its inside or outside counsel, and its internal or independent auditors. As noted above, section 8.30(f) specifically authorizes a director to rely on reports and information provided by officers or other employees so long as the director reasonably believes them to be reliable and competent, and on the advice of legal counsel, financial advisers, and other experts on matters that the director reasonably believes to be within their competence.

C. Interpretation and Application of the Balance Sheet Solvency Test

The balance sheet solvency test requires the corporation's assets, after the distribution, to at least equal its total liabilities (including senior liquidation preferences as liabilities, unless the charter permits otherwise).⁶³ The most important element of the balance sheet solvency test is the substantial latitude permitted to the board in determining whether the corporation is solvent in the balance sheet sense.

As noted above with respect to the equity solvency test,⁶⁴ the board may base its solvency determination “either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.”⁶⁵ Thus, the official comment to section 6.40(d) explicitly “contemplates that generally accepted accounting principles are always ‘reasonable in the circumstances’ and that other accounting principles may be perfectly acceptable, under a general standard of reasonableness”⁶⁶ The non-GAAP method that is most frequently employed by boards in making solvency determinations, especially balance sheet solvency, is probably the so-called “fair value” method. This method is particularly prevalent where the corporation has assets, for example, real estate, that have significantly appreciated over the value at which the assets are carried on the corporation's GAAP balance sheet (typically cost, perhaps less depreciation as well).

62. See *Gantler v. Stephens*, 965 A.2d 695, 706 (Del. 2009) (“[A] court will not substitute its judgment for that of the board if the [board's] decision can be attributed to any rational business purpose.” (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985)) (internal quotation marks omitted)).

63. MODEL BUS. CORP. ACT § 6.40(c)(2) (2008). See *supra* text following note 18.

64. See *supra* text accompanying note 49.

65. MODEL BUS. CORP. ACT § 6.40(d) (2008).

66. *Id.* § 6.40 cmt. 4(A).

In *Meeks*,⁶⁷ the court recognized that even intangible assets such as “name recognition and relationships with employees and clients” could be “some of the most valuable assets of a service firm.”⁶⁸ The court further observed that “[a] prospective buyer or associate (such [as] FSI) would find that goodwill valuable and be willing to pay for it.”⁶⁹

Of course, a fair-valuation balance sheet must be “reasonable in the circumstances.”⁷⁰ This means that it must be based on credible, reasonably current values of comparable assets. Although not required, valuation of assets by a knowledgeable, independent expert will tend to enhance credibility and, thus, the perception of the directors’ discharge of their duty of care. If the fair-valuation method is chosen, then it should not be applied selectively—no “cherry picking”—and all assets should be fair-valued. In addition, the values should be based on a method consistently applied to similar asset classes. Likewise, if the assets are fair-valued, then the liabilities should be fair-valued as well, absent circumstances that would make doing so not “reasonable in the circumstances.” Fair-valuing liabilities may often result in reducing them through discounting to present value on a risk-adjusted basis. This is generally reasonable as many (but not necessarily all) creditors prefer to be paid less now, rather than the full principal amount later (especially if the debtor is in a shaky financial condition). The size of any discount that a creditor is willing to accept will be influenced by the maturity, interest rate, prepayment penalty, and other terms, as well as the creditor’s assessment of the debtor’s financial condition and ability to pay the debt when due. A corporation seeking to fair-value its liabilities may enhance the credibility of its efforts by communicating directly with various creditors and finding out what they would take in current payment to discharge the obligation.

The MBCA does not explicitly state whether to treat as liabilities obligations such as rent and other future payments not normally included as liabilities on a balance sheet prepared according to GAAP. However, since the official comment to section 6.40 unequivocally states that GAAP is “always ‘reasonable in the circumstances,’”⁷¹ it is logical that balance sheets prepared on some non-GAAP basis that is also “reasonable in the circumstances” would not have to treat as liabilities non-balance sheet liabilities under GAAP. In any event, non-balance sheet obligations will generally be taken into account in applying the equity solvency test.

67. See *supra* text accompanying notes 56–60.

68. *Meeks v. PRN, Inc.*, No. 92-37019, 1994 U.S. App. LEXIS 23768, at *5 (9th Cir. Aug. 30, 1994).

69. *Id.*; see also *In re Fid. Bond & Mortg. Co.*, 340 B.R. 266, 289, 293, 301 (Bankr. E.D. Pa. 2006) (approving for the purposes of the balance sheet solvency test an insolvency analysis that included a value for “goodwill” as an asset), *aff’d sub nom. Fid. Bond & Mortg. Co. v. Brand*, 371 B.R. 708 (E.D. Pa. 2007).

70. MODEL BUS. CORP. ACT § 6.40(d) (2008).

71. *Id.* § 6.40 cmt. 4(A).

Several of these issues were on display in *Lerner v. Lerner Corp.*⁷² In that case, the corporation was a subchapter S corporation under the Internal Revenue Code, and the only stockholders were two brothers—Theodore, who owned 73.6% of the stock, and Lawrence, who owned 26.4%.⁷³ After years of squabbling and litigation, they reached a settlement providing that

[a] payment shall be made by Lerner Corp. to [Lawrence] after the end of each calendar year, beginning with calendar year 1988, equal to [his] proportionate share, based on the percentage of stock ownership, of the difference between the total amount of Lerner Corp.'s management income for such calendar year and the total amount of Lerner Corp.'s business expenses for such calendar year *which relate to management activities as distinguished from development activities.*⁷⁴

More litigation followed, as a result of which “a substantial sum of money was paid to Lawrence with interest.”⁷⁵ Concluding (on the basis of an opinion from outside counsel, a former Internal Revenue Commissioner) that it was necessary to make a proportionate payment to Theodore in order to preserve the corporation’s subchapter-S tax status, the corporation borrowed money to make the payment.⁷⁶ Lawrence asserted that the distribution to Theodore was unlawful because it violated Maryland’s equity solvency test, which is based on section 6.40 of the MBCA.⁷⁷ Theodore and Lerner Corporation did “not dispute that the corporation’s liabilities exceeded its assets for the period of time between the distribution and stock sale.”⁷⁸ The court held, nevertheless, that when determining whether the corporation would violate the balance sheet solvency test after the distribution, the “directors are entitled to consider a corporation’s current and future sources of cash.”⁷⁹ In upholding the Lerner Corporation board’s determination of *balance sheet solvency*, the court quoted from the MBCA: “In determining whether the *equity insolvency* test has been met, certain judgments or assumptions as to the future course of the corporation’s business are customarily justified, absent clear evidence to the contrary.”⁸⁰ If the court was aware that it was relying on equity insolvency language to address balance sheet solvency, it did not indicate it. Similarly, the court quoted from Fletcher:

The directors are entitled to make certain, reasonable judgments or assumptions about the future course of the corporation’s business. . . . The directors may utilize a cash flow analysis based on a business forecast and budget for a sufficient period of

72. *Lerner v. Lerner Corp.*, 711 A.2d 233 (Md. Ct. Spec. App. 1998).

73. *Id.* at 235.

74. *Id.* at 235 (alterations and emphasis in original).

75. *Id.* at 236.

76. *Id.*

77. *Id.* at 240.

78. *Id.*

79. *Id.* at 241.

80. *Id.* (emphasis added) (quoting MODEL BUS. CORP. ACT § 6.40 cmt. 2).

time and draw [a] conclusion that the corporation can reasonably expect to satisfy *known obligations as they mature* over that period.⁸¹

Although recognizing that “after the distribution to Theodore was made, the Corporation’s liabilities exceeded its assets,”⁸² the court concluded, on the basis of these two authorities, neither of which relates to balance sheet solvency and both of which expressly refer only to equity solvency, that

[u]nder these circumstances, it was reasonable for the directors of Lerner Corp., in determining whether the Corporation would remain solvent, to consider that the Corporation was going to raise additional cash by issuing additional stock, that the Corporation would be able to pay its debts as they became due, and that the loan utilized to fund the distribution to Theodore was guaranteed by an entity owned by Theodore. Therefore, there would be no violation of section 2-311 so long as the board exercised its discretion in good faith. There is no assertion by Lawrence that the board members acted other than in good faith.⁸³

Consideration of future cash needs and receipts is certainly relevant—indeed, fundamental—to an assessment of equity solvency, which is inherently forward-looking in its focus and determination. The very words “pay its debts as they become due” in section 6.40(c)(1) indicate a prospective application over a *period of time*. In the case of section 6.40(c)(1), that period of time begins once the distribution has been given effect. A balance sheet, on the other hand, is static; it speaks as of a particular *point in time*. In the case of section 6.40(c)(2), that point in time occurs immediately “after giving . . . effect” to the distribution. In both subsections (c)(1) and (c)(2), “giving effect to the distribution” means reducing the corporation’s assets by the amount of the proposed distribution (or, in the case of a distribution of corporate indebtedness, increasing the corporation’s liabilities) as of the time that the distribution is proposed to be made. There is no indication, in either the language of section 6.40’s official comment or elsewhere, that the point in time when balance sheet solvency is determined occurs after giving effect to the distribution. Indeed, it is hard to imagine when that point in time could be. There would be little reason or utility for a balance sheet solvency test that might (or might not) be satisfied at some indeterminate point in the future and then perhaps only briefly, even momentarily.

In *Lerner*, even though the stock issuance did, in fact, occur, generating sufficient funds to pay off the money borrowed by the corporation to make the distribution to Theodore, there was no contract or other commitment for the stock issuance at the time the board made its determination. It is pure speculation whether, under section 6.40(d), there might be “circumstances” in which it would be “reasonable” for the directors to base a solvency determination under section 6.40(c)(2) on a balance sheet giving prospective effect to an issuance of equity that no one had yet committed to buy on terms

81. *Id.* (emphasis added) (footnotes omitted) (quoting WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5329.10 (perm. ed. rev. vol. 1995)).

82. *Id.* at 240.

83. *Id.* at 241.

that had not yet been negotiated. Lawrence apparently did not even suggest it; Theodore and the Lerner Corporation therefore found no reason to address the question.

III

LEGAL CAPITAL REVISITED

It has been over a quarter-century since section 6.40 was added to the MBCA and, as noted above, it seems to be working well. It is firmly anchored on economically rational principles—equity solvency, balance sheet solvency, and fair value—that are familiar to business people, both borrowers and creditors, and relatively easy (with occasional exceptions) for lawyers and courts to understand and apply. Still, it is instructive and useful to ask whether improvements could be made.

Two United States courts of appeals have reached diametrically opposing positions on whether and, if so, under what circumstances a merger may be a “distribution” under the MBCA. It would be helpful if the Committee on Corporate Laws considered the issue and either modified the statute or the official comment to reflect its view. Other enhancements to the official comment could include clarifying the role played by non-balance sheet obligations in the board’s determination of both balance sheet and equity solvency. Also, it would be useful to expand on the process for fair-valuing liabilities, whether through discounting to present value or otherwise. When the comment was written, credit-default swaps, hedging programs, and other derivatives were still in their infancy—if they existed at all—and were not widely used to protect a company’s financial condition. Consideration should also be given to the extent and manner in which a board could properly take these instruments into account in determining both equity and balance sheet solvency. Likewise, risk management has become a central focus of board concern and that too may be an element a board should consider in assessing solvency.

Perhaps the largest question about section 6.40, however, is whether the balance sheet solvency test serves any useful purpose not already served by the equity solvency test. Consider the following two balance sheets:

Balance Sheet No. 1

Excess of assets over liabilities (balance sheet solvency), but inability to pay debts in the usual course of business (equity insolvency)

Assets		Liabilities	
Cash	\$100	Accounts Payable	\$500
Accounts Receivable	200	Notes Payable (Long-Term)	1000
Inventory	300		<hr/> \$1500
Plant and Equipment	600		
Real Estate	1000	Shareholders' Equity	
		Stated Capital	\$100
		Capital Surplus	400
		Retained Earnings	<hr/> 200
			<hr/> \$700
	<hr/> \$2200		<hr/> \$2200

In this balance sheet, the corporation has a healthy excess of assets over liabilities. But its excess of current liabilities (accounts payable) over current assets (cash and accounts receivable)—the so-called “current ratio”—leaves the corporation unable to pay its debts as they become due (equity insolvency). The fact that the corporation is balance sheet solvent does nothing for the creditors. The problem for creditors, rather, is the company’s inability to pay its debts in the usual course of business.

Now, consider the next balance sheet:

Balance Sheet No. 2

Deficit of assets over liabilities (balance sheet insolvency), but ability to pay debts in the usual course of business (equity solvency)

Assets		Liabilities	
Cash	\$1200	Accounts Payable	\$300
Accounts Receivable	400	Notes Payable (Long-term)	2500
Real Estate	600		
			\$2800
		Shareholders' Equity	
		Stated Capital	\$100
		Capital Surplus	400
		Retained Earnings	(1100)
			\$(600)
	\$2200		\$2200

In this balance sheet, the corporation has a significant deficit of assets over liabilities but also a significant excess of current assets (cash and accounts receivable) over current liabilities (accounts payable). So, the corporation is easily able to pay its debts as they are coming due at the present time, even though its total liabilities exceed its total assets. The balance sheet solvency test implicitly assumes that all the liabilities are due and payable currently, which, of course, is almost never completely the case. Further, as noted earlier, the official comment and the courts have recognized that the board is entitled to take into account a wide range of considerations in determining whether the corporation will be able to pay long-term liabilities that it might not now be able to pay. Thus, once again, it is the company's ability to pay its debts in the usual course of business that matters most to creditors—not the fact that it has more assets than liabilities.

Of course, the company should clearly be permitted under section 6.40(d) to write down its liabilities to what the creditors would currently accept in exchange for the debts. But that does not explain why the balance sheet solvency test actually helps creditors. Moreover, the balance sheet solvency test can lead to unintended or distortive results. For example, because of significantly lower share prices beginning in the second half of 2008, many U.S. companies found that their defined-benefit pension plans were substantially

underfunded due to the decrease in the value of the plans' assets.⁸⁴ This resulted in increased pension-funding liabilities for these companies and often severe reductions in shareholders' equity, thus threatening compliance with the balance sheet solvency test, even though these companies were generating significant revenue, earnings, and cash flow. Maryland addressed this problem by providing an exception to the balance sheet solvency test for Maryland corporations with net earnings in the current fiscal year, in the prior fiscal year, or in the prior eight fiscal quarters,⁸⁵ very much akin to Delaware's nimble-dividend provision.⁸⁶ The nimble-dividend approach, however, is not a refinement or enhancement to the balance sheet solvency test; rather, it is an exception to the test, underscoring the inadequacy and irrelevance of the balance sheet solvency test.

IV

CONCLUSION

The relatively smooth operation and interpretation of the MBCA's distribution provisions is an excellent example of the reflection, sophistication, care, and skill of the Committee on Corporate Laws in considering, drafting, revising, and updating the Model Business Corporation Act over the past sixty years. The overall success of the distribution provisions is also a tribute to the many lawyers, judges, and law professors who have participated in the Committee's very successful efforts to advance the law of corporations in this country and elsewhere—none more so than Bay Manning.

84. See *Underfunded Pension Plans*, FINANCIAL PLANNING ASSOCIATION, <http://www.fpanet.org/ToolsResources/ArticlesBooksChecklists/Articles/Retirement/underfundedpensionplans> (last updated Mar. 16, 2009) (discussing recent decreases in funding ratios for defined benefit plans).

85. Act of May 7, 2009, ch. 295, § 1, 2009 Md. Laws 1483, 1487.

86. DEL. CODE ANN. tit. 8, § 170 (2009).