THE MODEL BUSINESS CORPORATION ACT FINANCIAL PROVISIONS: A HISTORICAL SNAPSHOT

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I

INTRODUCTION

In 1980, the Committee on Corporate Laws (Committee) adopted sweeping amendments to the financial provisions of the Model Business Corporation Act (MBCA).[1] What these changes did, the forces that contributed to them, and the process of formulating them are excellent illustrations of how the Committee has worked over the years. These changes, which remain in the MBCA largely unchanged today, evolved during the decade of the 1970s and took effect in 1980, the midpoint in the existence of the MBCA from its inception in 1950 to its sixtieth anniversary this year.

During the life of the MBCA, many important changes have been made, usually involving multiple years of deliberation, debate, and refinement by committee members.[2] Most of the highly significant changes have involved making the MBCA's statutory provisions more detailed and lengthy than the existing ones. Examples of this are found in the provisions dealing with indemnification of directors and officers,[3] conflicting interest transactions,[4] fundamental changes,[5] and appraisal.[6] Another major addition to the MBCA, one of the most significant, actually had no counterpart at all in the then-

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This article is also available at http://www.law.duke.edu/journals/lcp.

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1. *See generally* Comm. on Corporate Laws, ABA Section of Bus. Law, *Changes in the Model Business Corporation Act—Amendments to Financial Provisions*, 34 BUS. LAW. 1867 (1979); Comm. on Corporate Laws, ABA Section of Bus. Law, *Changes in the Model Business Corporation Act—Amendments to Financial Provisions*, 35 BUS. LAW. 1365 (1980). All future references to the MBCA sections or official comments are to the MBCA as currently in effect unless an earlier date is designated.

2. For an example of the process, see *infra* text accompanying notes 26, 29, 30.

3. MODEL BUS. CORP. ACT ch. 8, subchapter E (2008). For a history of the changes, see MODEL BUS. CORP. ACT ANN. § 8.50 cmt. at 8-377 to -381 (4th ed. 2008).

4. MODEL BUS. CORP. ACT ch. 8, subchapter F (2008).

5. *Id.* chs. 9, 11.

6. *Id.* ch. 13.

existing MBCA: that was the introduction in 1998 of stated standards of liability of directors[7] as a companion to the stated standards of conduct for directors.[8]

Interestingly, on the one hand, the process of formulating the sweeping 1980 changes to the financial provisions of the MBCA, which were developed over more than half a decade, is typical of the way the Committee works. On the other hand, the end result of the process was different from most other major changes in their outcome when considered from the point of view of simplicity versus complexity. The changes eliminated a complex series of provisions that were out of date and, in the view of the Committee and other observers, largely obsolete and ineffective. The new provisions, which are essentially the same today, were simpler and clearer, even though they address fundamental elements of corporation finance and policy that are complex and ever changing.

II

FINANCIAL PROVISIONS BEFORE THE 1980 AMENDMENTS

Before the 1980 amendments, the MBCA financial provisions had remained largely unchanged from the inception of the MBCA in 1950. The structure of the financial provisions was grounded in the concepts of "net assets," "stated capital," "capital surplus," and "earned surplus." Dividends could be paid only out of "unrestricted and unreserved" earned surplus, subject to exceptions added in later for natural resource or "wasting asset" businesses and "nimble dividends," and a few exceptions such as elimination of preferred-stock dividend arrearages. Deficits in earned surplus could be eliminated or mitigated by procedures to reduce capital surplus. Capital surplus could be used to make distributions in "partial liquidation."[9] Of importance, the MBCA provided, as it provides today, that if dividends were declared and paid in violation of the requirements of the statute, directors had liability.[10]

When shares were issued, the consideration received was stated capital to the extent of par value, and the excess, if any, of the amount received over the par value was capital surplus; or, if the shares were of no par value, the entire consideration was stated capital, except that the directors were empowered to allocate amounts received for no par value shares to capital surplus prior to the time of issuance.[11]

Two developments in financial accounting posed serious issues under the MBCA's provisions relating to the issuance of shares and of determining the amount of earned surplus.

7. *Id.* § 8.31.

8. *Id.* § 8.30.

9. For a history of the MBCA financial provisions before the 1980 amendments, see MODEL BUS. CORP. ACT ANN. § 6.21 cmt. at 6-81 to -88, 6-236 to -241 (4th ed. 2008).

10. MODEL BUS. CORP. ACT § 43 (1950).

11. MODEL BUS. CORP. ACT ANN. § 6.21 cmt. at 6-85 (4th ed. 2008).

A. Pooling of Interests

One was the evolution of "pooling of interests" accounting in business combinations.[12] This accounting treatment, frequently employed in the 1960s and 1970s, brought forward, in the financial statements of the resulting entity in a merger or similar transaction that qualified for the pooling of interests treatment, the assets, liabilities, and earned surplus accounts of the constituent entities.[13] Many transactions were based on the ability to comply with this accounting treatment for several decades.[14] Under the MBCA provisions in effect before 1962, however, it appeared that the accounting for the issuance of shares in many forms of business combinations—involving the issuance of shares as the sole or primary consideration—would have added the value of the merged entity to capital, to the extent of the par value of the shares, with the balance being allocated to capital surplus. In 1962, the MBCA definition of earned surplus in section 2(*l*) was amended to permit the allocation of consideration in business combinations to earned surplus by adding a new second sentence. As amended, the definition read:

> "Earned surplus" means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date 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. Earned surplus shall include also any portion of surplus allocated to earned surplus in mergers, consolidations or acquisitions of all or substantially all of the outstanding shares or of the property and assets of another corporation, domestic or foreign.[15]

Section 21, the provision dealing with the accounting for the issuance of shares, was amended by adding the following third paragraph:

> If shares have been issued or shall be issued by a corporation in a merger or consolidation or in the acquisition of all or substantially all of the shares or of the property and assets of another corporation . . . any amount that would otherwise constitute capital surplus under the foregoing provisions of this section may instead be allocated to earned surplus . . . by the board of directors of the issuing corporation except that its aggregate earned surplus shall not exceed the sum of the earned surpluses as defined in this Act of the issuing corporation and all the other corporations, domestic or foreign, that were merged or consolidated or of which the shares or assets were acquired.[16]

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12. *See, e.g.*, ACCOUNTING PRINCIPLES BD., AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, BUSINESS COMBINATIONS (1970).

13. *Id.* As pooling of interests accounting evolved, many complexities and issues were introduced into structuring business combinations. *See e.g.*, Paul M. Fischer & Martin J. Gregorcich, *Pooling of Interests: An Expanded Role for the Corporate Attorney*, 56 MARQ. L. REV. 495 (1973); Larry P. Scriggins, *Business Combinations–Developments in Combining Techniques and Constraints in Accounting Rules*, 27 BUS. LAW. 1245 (1972).

14. This method of accounting was abolished in 2001. *See infra* note 41.

15. MODEL BUS. CORP. ACT § 2(*l*) (1969).

16. *Id.* § 21.

While this change, adopted in a number of states, did deal with an obvious problem, it was considered flawed by some commentators,[17] and, of course, was just a patch on the existing framework.

B. The Equity Method of Accounting

A second development in accounting standards again raised issues. In March 1971, the accounting profession's then standard setter, the Accounting Principles Board, issued APB 18, which provided for the "equity method" of accounting.[18] This standard required that the earnings or losses of a subsidiary *or* an affiliate be reflected, to the extent of the ownership share, in the financial statements of a parent or investor corporation if the investor's investment in voting shares of the investee gave it the ability to exercise significant influence upon the affairs of the investee, even though less than a fifty percent ownership interest existed. Importantly, an ownership interest of twenty percent or more gave rise to a presumption that the ability to exercise significant influence was present. Would earnings arising from this treatment constitute earned surplus available for the payment of cash dividends under the MBCA? The MBCA did not (and does not) deal with an enterprise on a consolidated basis or an "equity accounting" basis; its provisions are directed to "the corporation." At the time, "net assets" was defined as "the amount by which the total assets of a corporation exceed the total debts of a corporation."[19] "Surplus" was defined as "the excess of the net assets of a corporation over its stated capital."[20] Would any part of earnings reflecting profits of an affiliate recognized on the equity method of accounting constitute "net assets" and thus be a part of "surplus"? If so, would they be a part of "earned surplus," namely, the "surplus" that is "equal to the balance of its net profits, income, gains and losses"[21] within the meaning of section 2(*l*)? There was considerable uncertainty about these questions.

III

THE REVISIONS OF 1980

A. Debates of the Committee

The question concerning the equity method of accounting and other questions about the financial provisions of the MBCA were put in focus for the

17. *See, e.g.*, William P. Hackney, *Accounting for Mergers and Acquisitions under the New Jersey Business Corporation Act*, 23 RUTGERS L. REV. 689, 709–13 (1969) (noting, among other things, the inherent inaccuracies of asset valuation in a pooling).

18. ACCOUNTING PRINCIPLES BD., AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK (1971). This was effective for periods after December 31, 1971.

19. MODEL BUS. CORP. ACT § 2(i) (1969).

20. *Id.* § 2(k).

21. *Id.* § 2(*l*).

Committee beginning in the mid-1970s. Many believed that directors should be entitled to rely on financial statements prepared in accordance with generally accepted accounting principles for purposes of declaring dividends and repurchasing shares. At the same time, the Committee recognized that many privately held corporations did not prepare financial statements in accordance with generally accepted accounting principles; therefore, a mandate to follow generally accepted accounting principles would be flawed. In addition, while the MBCA was silent on the subject, many thought that case law dealing with "appraisal surplus" would apply under the MBCA.[22] Others questioned that conclusion.[23] The structure of the MBCA financial provisions generally had been questioned by a distinguished former chair of the Committee, who argued for the elimination of stated capital as a concept and for a focus on earnings instead.[24]

In the mid-1970s, the Committee established a subcommittee and authorized collaboration with the Section of Business Law's Committee on Law and Accounting, which in turn established a subcommittee, to work on a fundamental review of the basic financial provisions of the MBCA. The two subcommittees, working over several years, examined the history of the MBCA, reviewed views of commentators,[25] and had many debates about the fundamental purposes and results of the MBCA and other statutory provisions concerning financial matters. They examined the basic purpose of the legal-capital provisions—to protect creditors and senior equity-security holders; they explored whether or not other constraints might be appropriate for a corporation statute; and they deliberated questions on other problems such as the use of installment debt to redeem stock, often used by closely held corporations. They considered the practical need for the ability of directors to rely on financial statements prepared in accordance with generally accepted accounting principles as well as the fact that many closely held corporations do not prepare such financial statements and that, therefore, the directors of such corporations should be entitled to rely on other financial statements if reasonable in the circumstances.

At a meeting of the committee on March 5, 1977, the subcommittees reported their basic conclusions, the chief of which were that:

1. the concepts of par value, stated capital, and surplus (both earned surplus and capital surplus), as measuring constraints for dividends

22. *See, e.g.*, George C. Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act*, 38 VA. L. REV. 435, 440–43 (1952). Mr. Seward was Chair of the Committee from 1952 to 1958.

23. *See, e.g.*, William P. Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1366 (1957) (noting the MBCA's distinction between earned surplus and capital surplus).

24. *See* George D. Gibson, *Surplus, So What? The Model Act Modernized*, 17 BUS. LAW. 476, 492–94 (1962). Mr. Gibson was Chair of the Committee from 1962 to 1965.

25. *See* sources cited *supra* notes 22–24.

and stock repurchases, were outmoded and ineffective, and should be eliminated;

2. the statutory constraint on paying dividends and repurchasing stock should be a unified two-fold test of

A. insolvency in the equity sense (the ability to pay debts as they mature in the ordinary course of business), and

B. a balance-sheet test to the effect that after giving effect to the payments, assets should at least equal liabilities, with a proviso concerning senior-equity securities, either on the basis of a balance sheet based on generally accepted accounting principles or on a reasonable "fair value" basis;

3. other constraints were not appropriate for the corporation statute, and that other law of creditor's rights, including fraudulent-conveyances statutes, the federal bankruptcy law, equitable subordination, and the "thin corporation" case law, were appropriate and sufficient legal sources for creditor protection beyond the corporation statute; and

4. uncertainties existed about the issuance of promissory obligations in the redemption of shares.

This was followed by the distribution of a report on May 31, 1977, which was discussed at a meeting on June 24, 1977.[26]

After further deliberation, the two subcommittees submitted to the Committee another report dated January 4, 1978.[27] This report discussed the background and issues, reiterated the fundamental conclusions reported on March 5, 1977, and formulated proposed statutory amendments for consideration by the Committee. By that time, the subcommittees also had the benefit of a short textbook, published in 1977 by a distinguished scholar, Bayless Manning,[28] which analyzed the whole subject and stated conclusions similar to the subcommittee proposals. The proposals were debated and refined, and were approved on first reading at a meeting held December 8 and 9, 1978.[29] At a meeting held on April 7 and 8, 1979, further changes were adopted and the proposals were approved on second reading.[30] They were

26. Minutes of Meeting of the Comm. on Corporate Laws (June 24, 1977) (on file with author).

27. REPORT TO THE COMM. ON CORPORATE LAWS (Jan. 2, 1978) (on file with author).

28. Bayless Manning, A CONCISE TEXTBOOK ON LEGAL CAPITAL (1st ed. 1977). Professor Manning also joined the Subcommittee of the Committee on Law and Accounting in that year and contributed to the formulation of the proposals. Thereafter, he became a member of the Committee on Corporate Laws.

29. Minutes of Meeting of the Comm. on Corporate Laws (Dec. 8–9, 1978) (on file with author).

30. Minutes of Meeting of the Comm. on Corporate Laws (Apr. 7–8, 1979) (on file with author).

published in the July 1979 issue of the *Business Lawyer* and finally adopted on third reading in early 1980.[31]

B. Outcome of the Committee's Deliberations

The 1980 revisions remain largely intact in the MBCA today. Section 1.40(6) broadly defines "distribution" as follows:

> "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 its shareholders in respect of any of its shares. A distribution may be in the form of a dividend; a purchase, redemption or other acquisition of shares; a distribution of indebtedness; or otherwise.[32]

Section 6.40 governs distributions. It imposes the two-fold test of equity insolvency (that is, after giving effect to the distribution, the corporation must be able to pay its debts as they become due in the normal course of business); and the balance-sheet requirement that, after giving effect to the distribution, assets must at least equal liabilities plus (unless the articles of incorporation otherwise provide) an amount necessary to satisfy preferential rights of holders of shares whose preferential rights are senior to those receiving the distribution.[33] It entitles the board to base a determination that a distribution is not prohibited on the basis of accounting principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.[34] As stated in the official comment, financial statements prepared in accordance with generally accepted accounting principles are always reasonable in the circumstances, and other methods may be.[35] The official comment also gives guidance about the use of fair-valuation methods, including the admonition not to selectively revalue assets, but instead to revalue all assets and liabilities if a revaluation method is used.[36] Section 6.40 provides clarity as to the time of measurement of a distribution,[37] and deals specifically with issues arising with transactions involving the reacquisition of shares through the issuance of debt of the corporation.[38] A special section dealing with liability of directors for unlawful distributions remains in the MBCA, and provides that the party asserting liability must establish that the director did not comply with the general standard of care provided in section 8.30.[39]

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31. *See generally* Comm. on Corporate Laws, ABA Section of Bus. Law, *Changes in the Model Business Corporation Act–Amendments to Financial Provisions*, 34 BUS. LAW. 1867 (1979); Comm. on Corporate Laws, ABA Section of Bus. Law, *Changes in the Model Business Corporation Act–Amendments to Financial Provisions*, 35 BUS. LAW. 1365 (1980).

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

33. *Id.* § 6.40(c).

34. *Id.* § 6.40(d).

35. MODEL BUS. CORP. ACT ANN. § 6.41 cmt. at 6-231 (4th ed. 2008).

36. *Id.* at 6-232.

37. MODEL BUS. CORP. ACT § 6.40(e)–(g) (2008).

38. *Id.* § 6.40(f)–(g) (2008).

39. *Id.* § 8.33. The predecessor sections were section 43 of the 1950 and 1960 MBCA, and section 48 of the 1969 MBCA. Amendments of section 8.33 were adopted in 1987, 1998, and 2000. For a

IV

CONCLUSION

Very few changes to the basic MBCA financial provisions have been made since 1980.[40] This attests to the fundamental soundness of the 1980 changes and to the capacity of the financial provisions of the MBCA, as then amended and in present form, to remain valid in the midst of the constant evolution of accounting principles, methods of financial analysis, and sophisticated financial transactions, such as leveraged buyouts. For example, after three decades of use and mounting controversy, the Financial Accounting Standards Board abolished pooling of interests accounting for business combinations initiated after June 30, 2001.[41] Had the special amendments validating pooling of interests accounting adopted in 1962 remained in effect, they would have become irrelevant and probably would have been required to be eliminated from the MBCA.

Today, accounting standards and financial reporting are by no means free from controversy and continue to evolve. There has been a general tendency for accounting requirements to move further and further toward "fair value" or marking to market of assets, and away from historical cost less exhaustion or amortization charges. Now there are serious studies underway looking toward the harmonization of generally accepted accounting principles in the United States with international accounting standards.[42] The MBCA in its current form has easily accommodated changes in the past and should serve well to do so in the future as more evolution occurs.

The MBCA is only a model, and as such, has no real-world effect until state legislatures decide to follow it. Fortunately, a large majority of states have adopted the MBCA's 1980 approach to financial provisions and have in effect either the current MBCA provisions or substantially the basic approach taken in 1980.[43] Finally, as a historical observation about the traditions of the Committee, the deliberative process by which the 1980 financial provisions changes were developed is illustrative of the process by which the Committee has worked throughout its history to keep the MBCA evolving in the ever-changing landscape of corporate business activity, regulation, and law.

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detailed history of these changes, see MODEL BUS. CORP. ACT ANN. § 8.33 cmt. at 8-290 to -291 (4th ed. 2008).

40. *See* MODEL BUS. CORP. ACT ANN. § 6.40 cmt. at 6-241 to -242 (4th ed. 2008).

41. FIN. ACCOUNTING STANDARDS BD., STATEMENT NO. 141–BUSINESS COMBINATIONS 6 (2001).

42. *See, e.g.*, Commission Statement in Support of Convergence and Global Accounting Standards, Securities Act Release No. 9109, Exchange Act Release No. 61,578, 2010 WL 637050 (Feb. 24, 2010).

43. *See* MODEL BUS. CORP. ACT ANN. § 6.40 cmt. at 6-244 to -246 (4th ed. 2008).