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Jeff Keustermans

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Countertrends in Financial Provisions For the Protection of Corporate Creditors: The Model Business Corporation Act and the E.E.C. Corporate Directives

JEFF KEUSTERMANS*

I. INTRODUCTION

Distributions and payments of dividends by corporations to their shareholders are likely to cause a conflict of interest between shareholders and general creditors of a corporation. Shareholders generally expect a return on their investments as an enterprise earns profit, while creditors desire that an enterprise have substantial assets available for so long a time as their claims have not been paid.[1]

There are several alternative means to deal with the conflict. This article will focus on one in particular: corporate law restrictions on financial distributions to shareholders.[2] The goal of this article is to articulate trends in the applicable laws of the United States and E.E.C. Countries.[3] An analysis of these laws indicates that two countertrends can be discerned in the main bodies of laws governing corporations in the United States and the E.E.C. Countries. In particular, the second corporate E.E.C. Council Directive (1976) contains 44 articles on the raising and maintenance of share capital,[4] while the 1979 amendments to the final

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* Participant, Foreign Lawyer Program, Cleary, Gottlieb, Steen & Hamilton, New York, New York. L.L.M., University of California, Los Angeles, 1985; Lic. Juris, University of Leuven (Belgium), 1984; Certificate of European Business Law, City of London Polytechnic, 1982; and Cand. Juris, Saint Ignatius University of Antwerp (Belgium), 1981.

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1. B. MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL, 1-15 (2d. ed. 1981); Kummert, *State Statutory Restrictions on Financial Distributions by Corporations to Shareholders*, 59 WASH. L. REV. 185, 189-193 (1984).

2. Restrictions that result from the operation of the state's fraudulent conveyance rules will be covered only where necessary. For a discussion of these restrictions *see* Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505 (1977). *See also* Kummert, *supra* note 1, at 266-282.

3. This evolution was primarily inspired by the Second Council Directive of 13 December 1976, on coordination of safeguards which are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty. 20 O. J. EUR. COMM. No. 126, 1 (1976) [hereinafter cited as Second Council Directive].

4. Morse, *The Second Directive: Raising and Maintenance of Capital*, 2 EUR. L. REV. 126 (1977); Yates III, *European Directives on Formation and Operation of Companies and the Role of the Lawyer*, in VA. LEGAL STUDIES, HARMONIZATION OF LAWS IN THE EUROPEAN

provisions of the Model Business Corporation Act (MBCA) have eliminated "the outmoded concepts of stated capital and par value."[5]

This article will present an overview of the basic terminology and operation of the statutory "legal capital" systems. The article will then examine solutions adopted by the revisors of the MBCA, by the state of California and other states that followed in the wake of these changes. For comparative purposes, the requirements for the protection of creditors in the E.E.C. Countries will be discussed. It will be pointed out that European legislators have created more severe requirements than their U.S. counterparts for the raising and maintenance of a minimum capital, which serves as a trust fund for the protection of creditors.

Finally, the author will propose a new solution to the conflict of interest between shareholders and general creditors of a corporation, following the examples of the California Corporation Code and the MBCA in so far as they are based on financial ratio tests.

II. THE MBCA

The MBCA provides the basis for the corporation laws of a majority of states within the United States. [6] At a meeting on December 8, 1979, the Committee on Corporate Laws of the American Bar Association (Section on Corporation, Banking and Business Law) adopted far-reaching revisions to the financial provisions of the MBCA which have been made

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COMMUNITIES 113, 118 (1983).

5. *Changes in the Model Business Corporation Act - Amendments to Financial Provisions, A Report of the Committee on Corporate Laws*, 34 BUS. LAW. 1867 (1979) [hereinafter cited as *Amendments*]. *See* text accompanying notes 44-55.

6. The Model Business Corporations Act has served as the basis for corporate codes in more than twenty five states and was employed to a great extent in the drafting of the corporate law statutes of about ten other states. 1 MODEL BUSINESS CORP. ACT ANN. § 2, comment 4 (1971); MODEL BUSINESS CORP. ACT ANN. § 1, comment 1 (1973 Supp.); MODEL BUSINESS CORP. ACT ANN. § 1, comment 1 (1977 Supp.); *See* Cohn, *Capital Structure, Dividends and Redemption - Time for a Change to Florida's Corporate Code*, 56 FLA. B.J. 574, 577 n.2 (1982); Murphy, *Redemption of Stock Under the Model Business Corporation Act and the Virginia Stock Corporation Act*, 14 U. RICH. L. REV. 311 (1981); Branson, *Countertrends in Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure*, 68 MINN. L. REV. 53, 57 (1983); Kummert, *supra* note 1, at 195; B. MANNING, *supra* note 1, at 73 and 165; The Model Business Corporation Act was prepared by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association. A first draft of a model business corporation act (1946) was patterned on the 1933 Illinois Business Corporation Act. A version in 1950, which largely superseded the first draft, was given wide publicity and may be regarded as the basis of the present Model Business Corporation Act. For the text of the 1950 version, preceded by comments on the early drafts, see Garrett, *History, Purpose and Summary of the Model Business Corporation Act*, 6 BUS. LAW. 1 (1950); *see also* Garrett, *The Model Business Corporation Act*, 4 BAYLOR L. REV. 412 (1952); Harris, *The Model Business Corporation Act - Invitation to Irresponsibility?*, 50 NW. U.L. REV. 1 (1955); Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROBS. 193, 197 (1958).

part of the overall revision of the Act in 1984, after only minor changes.[7] To date, very few states have adopted the revised MBCA. The majority of states have corporation laws based on the old MBCA and its predecessors.

A. *Statutory "Legal Capital" Systems*

The concepts of "legal capital," "par value," "stated capital," and "capital surplus," contained in the modern corporation codes of most states are the direct product of nineteenth century legal history.[8] In the nineteenth century, "par value" was the minimum value that a shareholder was required to have paid for each share of corporate stock.[9] The product of the par value of each share times the number of shares of stock issued and outstanding was called the corporation's "capital" or "stated capital."[10] If the shares were authorized at a low value, and sold well in excess of it, they were called "low par stock."[11] Consideration received in excess of the par value was separately disclosed on the balance sheet as "capital surplus," "capital in excess of par value" or "additional paid-in capital."[12]

Par value is no longer an indication of the price at which shares are issued. Today, the only important function of par value is that consideration at least equal to par must be paid in under the statutes. If the assets paid in for shares are valued at an amount less than par, the shares are called "watered stock."[13] Most statutes permit a statutory obligation to pay in par value to be enforced in some circumstances by creditors,[14]

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7. *Changes in the Model Business Corporation Act - Amendments to Financial Provision, A Report of the Committee on Corporate Laws*, 35 BUS. LAW. 1365 (1980); T. FIFLIS, H. KRIPKE, P. FOSTER, ACCOUNTING FOR BUSINESS LAWYERS, 431 (3rd ed. 1984) [hereinafter cited as T. FIFLIS]; R. HAMILTON, CORPORATION FINANCE, 114 (1984); Murphy, *Equity Insolvency and the New Model Business Corporation Act*, 15 U. RICH. L. REV. 839 (1981); Ralston, *The 1980 Amendments to the Financial Provisions of the Model Business Corporation Act: A Positive Alternative to the New York Statutory Reform*, 47 ALB. L. REV. 1019, 1021-1022 (1983); B. MANNING, *supra* note 1, at 165; Kummert, *supra* note 1, at 187 n.4; Cohn, *supra* note 6, at 578 n. 32; Murphy, *supra* note 6, 312 n.3; *Amendments supra* note 5. The official text and comments of the 1984 overall revision of the Model Business Corporation Act were published in 1985 as the REVISED MODEL BUSINESS CORP. ACT. Throughout this text, the latest 1984 version of the Model Business Corporation Act is referred to as the "MBCA." The version of the sections as they existed prior to the 1979 amendments is referred to as the "old MBCA."

8. Cohn, *supra* note 6, 574; The concepts and their history are discussed extensively in B. MANNING, *supra* note 1, at 1-108.

9. B. MANNING, *supra* note 1, at 20; T. FIFLIS, *supra* note 7, at 426.

10. B. MANNING, *supra* note 1, at 30; Cohn, *supra* note 6, at 574.

11. B. MANNING, *supra* note 1, at 24.

12. S. SIEGEL & D. SIEGEL, ACCOUNTING AND FINANCIAL DISCLOSURE, 98-99 (1983) B. MANNING, *supra* note 1, at 36; Cohn, *supra* note 6, at 574; Ralston, *supra* note 7, at 1023.

13. B. MANNING, *supra* note 1, at 20; R. HAMILTON, *supra* note 7, at 66; T. FIFLIS, *supra* note 7, at 426; S. SIEGEL & D. SIEGEL, *supra* note 12, at 97.

14. Hackney & Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 839 (1982); B. MANNING, *supra* note 1, at 46.

shareholders,[15] or the corporation.[16]

Since the beginning of this century[17] more and more states have permitted the issuance of "no par stock" (i.e. stock with no dollar amount printed on the share certificate). No par stock may be issued for whatever consideration the board of directors determines.[18] The statutes, however, require that the board of directors "state" a capital number on the balance sheet.[19] This number, whether or not it follows directly from the par value of the shares is called the "legal capital" or "stated capital". Some statutes prescribe a minimum initial capitalization;[20] which is typically a requirement to pay in a small amount of money, very often $500 or $1,000.[21] Most of these *pro forma* requirements have been abolished during the last few years.[22]

A shareholder has no financial obligation or liability to the corporation or its creditors with respect to his shares, other than the obligation to pay the consideration for which his shares were issued.[23] The legal capital required by law is designed to be a safeguard for creditors.[24] But in some cases, particularly where the corporation is "grossly undercapitalized," this limited liability may be disregarded.[25]

Many states base restrictions on corporate distributions on the concept of legal capital. In effect, this concept asserts that a corporation, in order to protect its creditors, should not pay any dividend to its shareholders if the result would be to reduce the corporation's assets below the aggregate par or stated value of issued shares.[26] The problems involved in

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15. B. MANNING, *supra* note 1, at 53.

16. *Id.* at 56.

17. *Id.* at 25.

18. Cohn, *supra* note 6, at 574; T. FIFLIS, *supra* note 7, at 427; S. SIEGEL & D. SIEGEL, *supra* note 12, at 97.

19. B. MANNING, *supra* note 1, at 26; Cohn, *supra* note 6, at 574; S. SIEGEL & D. SIEGEL, *supra* note 12, at 97. Some statutes treat stated value like par: if the stated value is not paid-in, it will be possible to enforce payment of the stated value. T. FIFLIS, *supra* note 7, at 427.

20. R. HAMILTON, *supra* note 6, at 56.

21. 2 MODEL BUSINESS CORP. ACT ANN., 174, § 54, ¶ 3.03(7) (1971). Usually there was no provision prohibiting an immediate return of this amount to the shareholders. B. MANNING, *supra* note 1, at 17.

22. The old MBCA contained such a provision, but it was eliminated in 1969. 2 MODEL BUSINESS CORP. ACT ANN. § 54, ¶ 3.03(7) (1971); Scott, *Changes in the Model Business Corporation Act*, 24 BUS. LAW. 291, 300 (1968); R. HAMILTON, *supra* note 7, at 56; Branson, *supra* note 6, at 77.

23. 1 MODEL BUSINESS CORP. ACT ANN. § 25 (1971); Hackney & Benson, *supra* note 14, at 839.

24. Hackney, *Accounting Principles in Corporation Law*, 30 LAW & CONTEMP. PROBS. 791, 799 (1965).

25. *See* Comment, *Limited Limited Liability, A Definitive Judicial Standard for the Inadequate Capitalization Problem*, 47 TEMP. L. Q. 321 (1974); Hackney & Benson, *supra* note 14, 837-901; *see infra* notes 127-130 and accompanying text.

26. Kummert, *supra* note 1, at 194; B. MANNING, *supra* note 1, at 30; T. FIFLIS, *supra* note 7, at 432; Hackney, *supra* note 24, at 799.

determining the legality of distributions under these statutes are generally seen as among the most confusing and complex in the entire field of corporate law.[27] The statutory provisions differ from state to state and contain different tests. It will be useful to mention the most important forms of state legislation which impose restrictions on corporate distributions.

1. *Insolvency Statute*

Massachusetts appears to be the only state which has only one statutory limitation on distributions of assets to shareholders. The Massachusetts corporation statute imposes liability on directors of a corporation who distribute dividends "if the corporation is insolvent or is rendered insolvent by the making of any such distribution. . . ."[28] This provision is generally seen as the most lenient in terms of restricting distributions. It dispenses entirely with concepts of capital, legal capital, par value, surplus or any other accounting terms. Most corporation laws of other states contain similar provisions, but only in combination with one or more of the tests discussed in the following sections.[29]

2. *Balance Sheet Surplus Statutes*

The New York Business Corporation Law is a good example of a balance sheet surplus statute. Section 510(b) reads as follows:

> Dividends may be declared or paid and other distributions may be made out of surplus only, so that the net assets of the corporation remaining after such declaration, payment or distribution shall at least equal the amount of its stated capital.[30]

The effect of this test is that dividends may be paid out of net assets in excess of legal capital.[31] These provisions rely heavily on accounting concepts that determine whether there is a surplus.[32]

3. *Earned Surplus Statutes*

According to these statutes, distributions of assets to shareholders

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27. R. HAMILTON, *supra* note 7, at 84.

28. MASS. GEN. LAWS ANN. ch. 156B, § 61 (West 1964); *Current Issues on the Legality of Dividends From a Law and Accounting Perspective: a Task Force Report*, 39 BUS. LAW. 289, 304 (1983) [hereinafter cited as *Task Force Report*]. *See also* Colorado Corp. Code, C.R.S. § 7-5-110(1) (1973).

29. B. MANNING, *supra* note 1, at 59; Cohn, *supra* note 6, at 575; R. HAMILTON, *supra* note 7, at 85; T. FIFLIS, *supra* note 7, at 441.

30. N.Y. BUS. CORP. LAW § 510(b) (Consol. 1982). More than fifteen states use this test as the central restriction on distributions of assets. *E.g.* C.R.S. § 7-5-110(d) (1973); *Kummert, supra* note 1, at 211. For a definition of stated capital see N.Y. BUS. CORP. LAW § 102(a)(12) (Consol. 1982); MICH. COMP. LAWS § 450.1109(3) (1970); 1 MODEL BUSINESS CORP. ACT ANN. § 2(j) (1971).

31. T. FIFLIS, *supra* note 7, at 434.

32. S. SIEGEL & D. SIEGEL, *supra* note 12, at 99.

have to be limited to situations in which an enterprise has accumulated earnings. The old MBCA is often described as an earned surplus statute.[33] Section 45(a) of the old MBCA permits dividends to be declared and paid in cash or property out of the unreserved and unrestricted earned surplus.[34] Earned surplus consists of the accumulated and undistributed earnings of the corporation.[35]

This limitation seems to provide adequate protection for creditors. However, according to section 46 of the old MBCA, a corporation may under certain conditions distribute cash or property out of capital surplus.[36] This "exception" is probably based on the idea that it is only the par value of the corporation's stock that serves to protect the creditors.[37] Capital surplus which can be generated quite easily by a reduction of par or other reduction of stated capital can be used as an offset to a deficit in the earned surplus account.[38]

4. *Nimble Dividend Statutes*

Section 170 of the Delaware corporation statute permits a corporation to pay dividends in situations where there will be no surplus. These dividends are paid out of net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. Dividends can be paid

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33. Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1366-1367 (1957); B. MANNING, *supra* note 1, at 73; Murphy, *supra* note 6, at 315; T. FIFLIS, *supra* note 7, at 436.

34. 1 MODEL BUSINESS CORP. ACT ANN. § 45(a) (1971).

35. For the complete definition see 1 MODEL BUSINESS CORP. ACT ANN. § 2(l) (1971).

36. In part, section 46 of the old Model Act states:

> (a) No such distribution shall be made at a time when the corporation is insolvent or when such distribution would render the corporation insolvent.
>
> (b) No such distribution shall be made unless the articles of incorporation so provide or such distribution is authorized by the affirmative vote of the holders of a majority of the outstanding shares of each class whether or not entitled to vote thereon by the provisions of the articles of incorporation of the corporations.
>
> (c) No such distribution shall be made to the holders of any class of shares unless all cumulative dividends accrued on all preferred or special classes of shares entitled to preferential dividends shall have been fully paid.
>
> (d) No such distribution shall be made to the holders of any class of shares which would reduce the remaining net assets of the corporation below the aggregate preferential amount payable in event of involuntary liquidation to the holders of shares having preferential rights to the assets of the corporation in the event of liquidation.
>
> (e) Each such distribution, when made, shall be identified as a distribution from the capital surplus and the amount per share disclosed to the shareholders receiving the same concurrently with the distribution thereof.

1 MODEL BUSINESS CORP. ACT ANN. § 46 (1971). *See also* Kummert, *supra* note 1, at 196; Murphy, *supra* note 6, at 316 n. 10.

37. S. SIEGEL & D. SIEGEL, *supra* note 12, at 99.

38. *See* 2 MODEL BUSINESS CORP. ACT ANN. § 70 (1971); B. MANNING, *supra* note 1, at 72-75,125; Hackney, *supra* note 33, at 1381.

out even if the deficits of previous years have not yet been eliminated.[39]

This approach can be risky for creditors because this provision allows future dividends to be paid despite accumulated past deficits. However, it does allow a corporation that has accumulated large losses to attract new equity capital. If this new capital infusion can help a company avoid bankruptcy, the creditors certainly would be better off. But even then, it would be preferable to allow "nimble" dividends only up to a limited portion, such as fifty percent of the current earnings, and to require that the other part of these earnings be used to reduce the existing deficit.

B. *New Financial Provisions*

The reformation of state statutes that regulate payments by corporations to their shareholders began with the adoption by the California legislature of the California General Corporations Law.[40] The fundamental limitation on corporate distributions has been retained in Section 501 of the California Corporation Code which provides that no distribution may be made if the corporation is, or as a result of the distribution would be unable to pay its debts as they mature.[41]

The California statute further prohibits any distribution to the corporation's shareholders unless: (a) the corporation has retained earnings at least equal to the amount of the proposed distribution,[42] or (b) the corporation, after the distribution, has (1) assets at least equal to 1¼ times its liabilities, and (2) current assets at least equal to its current liabilities. If the corporation's earnings for the two preceding fiscal years before taxes on income and interest expense are less than its interest expense for those same years, its current assets must at least be equal to 1 ¼ times its liabilities.[43] These tests are in fact financial ratios used to

39. DEL. CODE ANN. tit. 8, §170 (1980); *see also* T. FIFLIS, *supra* note 7, at 434; B. MANNING, *supra* note 1, at 76-77.

40. *See* Act of Sept. 12, 1975, ch. 682, 1975 CAL. STAT. 1514. The amendment of the financial provisions was the most revolutionary part of an overall revision of the California Corporation Code. The new California General Corporation Law took effect on January 1, 1977.

41. CAL. CORP. CODE § 501 (Deering 1977). This is called the equity insolvency test, which is concerned with liquidity. Equity insolvency can be defined as the inability to pay debts as they become due. The bankruptcy insolvency test is concerned with liquidation and compares the total dollar amount of the assets with the total dollar amount of the liabilities. There is bankruptcy insolvency if the total liabilities exceed the total assets. *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, 380 (1983); B. MANNING, *supra* note 1, at 59-60.

42. CAL. CORP. CODE § 500(a) (Deering 1977).

43. CAL. CORP. CODE § 500(b) (Deering 1977). Assets are defined as "exclusive of goodwill, capitalized research and development expenses and deferred charges" and liabilities as "not including deferred taxes, deferred income and other deferred credits." For more extensive discussions of these provisions, *see* 2 H. MARSH, CA. CORP. LAW AND PRACTICE, § 13.1-13.30 (1982); R. CLARK, 1 CA. CORP. LAWS, §§ 141-148 (1984); Ackerman, Jr., *California's New Approach to Dividends and Reacquisitions of Shares*, 23 UCLA L. REV. 1052 (1976);

determine the solvency of the corporation. The "revolution" started by the California legislation was continued some years later when the financial provisions of the old MBCA were amended. Today's MBCA contains comparable, but different provisions.[44]

Shortly after the adoption of the 1979 amendments, the Committee on Corporate Laws of the American Bar Association began a major project to update, restate and revise all provisions of the MBCA. A final version was approved in 1984 and published in 1985. As mentioned earlier, this revision contains no substantial changes to the 1979 amendment.[45] Illinois, Montana and New Mexico have already enacted all or some of the new provisions in their corporation law.[46]

The most important change made by the amendments to the MBCA was the elimination of par value, stated capital and surplus.[47] The use in the articles of incorporation of provisions concerning par value (for whatever purposes desired, not inconsistent with the statute) is optional.[48] The purchasing shareholder has no other obligation to the corporation nor to its creditors than to pay the consideration for which the shares were authorized to be issued or which is specified in the subscription agreement.[49] No certificate shall be issued for any share before the board of directors determines that the consideration received or to be received for the shares is adequate.[50] There is no requirement of minimum initial capitalization.

Central to the changes is the introduction of a new concept termed "distribution," and the revision of the rules regulating dividends and purchases by a corporation of its own shares and distributions in liquidations. According to the Act, stock dividends and stock splits are not "distributions." They are mere changes in the unit of interests.[51] Section 6.40(c) of the MBCA imposes a uniform test on all distributions. A corpo-

Dreyfuss, *Distributions to Shareholders Under the New California General Corporation Law*, 9 LOY. L.A.L. REV. 839 (1976); Kummert, *supra* note 1, at 226-242; Ben-Dror, *supra* note 41.

44. *See* Ben-Dror, *supra* note 41, at 377 n.22 and 381-383.

45. *See supra* note 7.

46. Illinois, ILL.ANN.STAT. ch. 32P. § 9.15 (1985); New Mexico, N.M. STAT. ANN. § 53-11-44 (1983); Montana, MONT. CODE ANN. § 35-1-711 (1983).

47. *Amendments, supra* note 5, at 1869-1872; *See also supra* notes 35-37 and accompanying text.

48. *Amendments, supra* note 5, at 1887. Of course, many charter documents will not be changed and continue to contain references to par value.

49. REVISED MODEL BUSINESS CORP. ACT § 6.22(a) (1985). *Compare with* section 25 of the old MBCA, *see supra* note 23 and accompanying text.

50. REVISED MODEL BUSINESS CORP. ACT § 6.21(c) (1985).

51. REVISED MODEL BUSINESS CORP. ACT § 1.40(6) (1985). A "distribution" is defined as: " 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. 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."

ration may not make a proposed distribution if either: (1) the corporation would not be able to pay its debts as they become due in the usual course of its business, or (2) the corporation's total assets would be less than the sum of its total liabilities (unless the articles of incorporation permit otherwise) plus the amount that then would be needed to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.[52] This test is in fact a dual insolvency test which prohibits any distribution that causes either "equity insolvency," or "bankruptcy insolvency."[53]

Determination that a distribution may be made under section 6.40(c) of the MBCA may be based on financial statements prepared on the basis of accounting practices and principles, on a fair valuation, or on other methods that are reasonable under the circumstances.[54] Section 6.40(e) also provides the effective date by which the distribution is to be measured.[55]

III. CORPORATION LAW IN THE E.E.C. COUNTRIES

Corporation Law in the E.E.C. Countries is heavily influenced by Community Directives. After giving an overview of the basis in the E.E.C. Treaty[56] for the directives and their operation in general, we will discuss in detail the different directive requirements protecting general creditors. It will be clear that the European system is similar to the U.S. systems of legal capital in many ways. However, the European system has more stringent requirements for the raising and maintenance of minimum capital than its United States counterparts.

A. *Harmonization of Corporate Laws in the E.E.C.*

One aspect of the E.E.C.'s goal to permit the free movement of persons, services and capital among Member States is what the E.E.C. Treaty terms the right of establishment. This right comprises the freedom of a national company of any Member State to establish or maintain a business in any of the other Member States. The E.E.C. Council of Ministers has the power to issue directives to the Member States in order to secure freedom of establishment by means of coordinating some aspects of the national corporation laws of the Member States.[57] Although

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52. REVISED MODEL BUSINESS CORP. ACT § 6.40(c) (1985).

53. *See supra* note 41.

54. REVISED MODEL BUSINESS CORP. ACT § 6.40(d) (1985).

55. For further discussion of the MBCA: B. MANNING, *supra* note 1, at 165-180; Kummert, *supra* note 1, at 242-256; Cohn, *supra* note 6, at 576-578; Murphy, *supra* note 7, at 839-871; Ralston, *supra* note 7, at 1019-1049.

56. Treaty Establishing the European Economic Community, *done* March 25, 1957, art. 85, 298 U.N.T.S. 3 [hereinafter referred to as E.E.C. Treaty].

57. *Id.* arts. 53(3)(g), 54(2). For a more detailed analysis of the legal foundation of these measures in the E.E.C. Treaty, see Schneebaum, *Company Law Harmonization Program of the European Community*, 14 LAW. & POL'Y. INT'L BUS. 293, 293-300 (1982); Wooldridge,

directives are binding upon each Member State to which it is addressed, "as to the result to be achieved,"[58] the directives claim to leave the national authorities the choice of form and methods, but in practice they often leave little discretion as to the manner of their implementation.[59]

A plan of company law harmonization has been developed and partly executed in the E.E.C. Countries. This plan covers diverse aspects of corporate operations including disclosure of information, capitalization, mergers, public offerings of securities, qualification of auditors and relationships within "groups" of corporations.[60] Those areas of law which are not governed by implementation within the national laws of any directive are still governed by the national laws and regulations of each Member State.[61]

B. *The Second Council Directive*

Distribution to shareholders in E.E.C. Countries is primarily regulated by the Second Council Directive.[62] The Second Directive applies only to public companies and not to private companies.[63] The term "public company" is defined to include the public company limited by shares, limited by guarantee and having a share capital (United Kingdom, Ireland), die Aktiengesellschaft (Germany), la society anonyme (France, Belgium), de naamloze venootschap (Netherlands, Belgium), la societa per azioni (Italy) and aktieselskabet (Denmark).[64] Member States need not apply the Directive to investment companies with variable capital nor to co-operatives, which take the form of public companies, if they require these companies to mention their special status in their business documents.[65]

Although article 43 of the Second Directive requires implementation of the Directive in the national law of each Member State within two

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Harmonization of Company Law: The First and Second Directives of the Council of Ministers of the European Economic Community, ACTA JURIDICA 327, 327-328 (1978); Frédéricq, *Harmonisatie van het vennootschapsrecht in de Europese Económische Gemeenschap, hoever staan wij?*, 43 RECHTSKUNDIG WEEKBLAD, 1809, 1822-1823 (1980); Yates, III, *supra* note 4, at 113-115.

58. E.E.C. Treaty, *supra* note 56, art. 189.

59. Wooldridge, *supra* note 57, at 328.

60. *See* Nieuwdorp, *Status Report on E.E.C. Company Law Harmonization*, 12 INT'L BUS. LAW. 425-430 (1984); Schneebaum, *supra* note 57, at 301-321; Frédéricq, *supra* note 57, at 1822-1840.

61. Where the subject of this article is not covered by any E.E.C. Directive, or where otherwise useful, this article will refer to the law of the E.E.C. Countries with which the author is most familiar.

62. Second Council Directive, *supra* note 3. For the legislative history of the Directive, see Schmitthoff, *The Second EEC Directive on Company Law*, 15 COMM. MKT. L. REV. 43, 43-46 (1978).

63. Morse, *supra* note 4, at 127; Wooldridge, *supra* note 57, at 334; Schmitthoff, *supra* note 62, at 45.

64. Second Council Directive, *supra* note 3, art. 1.1.

65. *Id.* art. 1.2.

years of its notification, many Member States have implemented it much later.[66] The delay stems not from ideological rejection, but from the fact that in some Member States a more general revision of the code was proceeding simultaneously, in some cases provoked by the implementation of the Directive.[67]

1. *Provisions for Corporation Distributions to Shareholders*

The Second Directive provides special rules for the raising and maintenance of share capital that are much stricter than any "legal capital" system in the United States. Article 6 of the Second Directive requires that a public company may not be incorporated or authorized to commence business unless a minimum capital of at least 25,000 European Units of Account are subscribed.[68] Member States often require a larger minimum capital.[69] Most E.E.C. Countries already had a requirement of a minimum capitalization in their corporation law.[70]

The Second Directive contains provisions to keep the minimum amount, stated in the Directive and implemented in the national laws,

66. Schneebaum, *supra* note 7, at 304 n.46; *Belgium*, Law of December 5th, 1984, MONITEUR BELGE-BELGISCH STAATSBLAD, 15612 (Dec. 12, 1984); *see* Francois, van Bruystegem, Massagé, van Hulle, Debrulle, Verhaegen, Olivier essays in LA MODIFICATION DU DROIT DES SOCIETES ANONYMES, REVUE DE DROIT COMMERCIAL BELGE (special edition) (1984) [hereinafter cited as LA MODIFICATION BELGE]; Glansdorf, *Projet de loi sur les sociétés commerciales*, 101 JOURNAL DES TRIBUNAUX 171-176 (1982); *France*, Law of December 30th, 1981, 1982 J.C.P. 111 52152; Coffy, *Loi No. 81-1162 du 30 décembre 1981 relative a l'harmonisation du droit des sociétés commerciales avec le lle. directive de la C.E.E. du 13 décembre 1976*, DALLOZ SIREY, CHRONIQUE 279, 279-292 (1982), and Guyon, *La mise en harmonie du droit francais des sociétés avec la directive des Communautés Européennes sur le capital social*, 1982 J.C.P. No. 1, 3067.

67. Massagé, *Adaption des lois coordonnées sur les sociétés commerciales à la Deuxième directive des Communautés Européennes relative à la constitution de la société anonyme, au maintien et aux modifications de son capital*, 96 JOURNAL DES TRIBUNAUX 125, 125 (1981); Coffy, *supra* note 66, at 279.

68. The European Unit of Account is constituted by a "basket" of community currencies and has been replaced by the European Currency Unit (ECU) in all Community legal instruments. *See* Council Regulation 3308/80 of 16 Dec., 1980, 23 O.J. EUR. COMM. No. L345, 1 (1980). The ECU is also a basket of currencies defined in the same way as the European Unit of Account, but subject to a revision clause. *See* Council Regulation 3180/78 of 18 Dec. 1978, 20 O.J. EUR. COMM. No. L 379, 1 (1978). The value of the ECU was approximately $0.88 on Jan. 21, 1986, Wall Street J. Jan. 21, 1986, at 55.

69. *E.g.*, *France*, 250,000 FF, and 1,500,00 FF if the corporation "goes public;" *see* Y. GUYON, DROIT DES AFFAIRES 270 (3rd. ed., Paris, 1984); Guyon, *supra* note 66, at No. 9; Coffy, *supra* note 66, at 284. *Belgium*, 1,250,000 BF, *See* Francois, LA MODIFICATION BELGE, *supra* note 66, at 14. In Belgium there are no extra requirements as to minimum capitalization when a firm goes public. The Belgian Commission Bancaire focuses especially on the efficient disclosure to the prospective buyer. (Royal Decree nr. 185, July 9th, 1935); *See* Geeraert, Keustermans, *De openbare uitgifte van effecten, Recht en Praktijk*, 19 JURA FALCONIS 315, 315-355 (1983). *Germany*, 100,000 DM, *see*, *Hüffer, Harmonisierung des aktienrechtlichen Kapitalschutzes*, 32 NEUE JURISTISCHE WOCHENSCHRIFT 1065, 1070 (1979).

70. *E.g. France*, art. 71, Law No. 66-537 of July 24th, 1966; *Germany* § 7 AKtG; *Italy*, art. 2327 Codice Civile.

adequate in the light of fluctuations of currencies and the economic and monetary trends in the Member States.[71]

Shares issued for cash are paid at the time the company is incorporated or authorized to commence business, at not less than twenty-five percent of their nominal value, or in absence of a nominal value, their accountable par. Where shares are issued for a consideration other than in cash, the consideration must be transferred in full within five years of that time.[72]

The subscribed capital may be formed only of assets capable of economic assessment. Excluded are undertakings to perform work or supply services.[73] Articles 10 and 11 of the Second Directive contain special rules for the valuation of capital contributions in kind, including a requirement for a valuation report, before the company is incorporated or authorized to commence business, by one or more independent experts appointed or approved by an administrative or judicial authority.[74] Because the guiding principle underlying this provision of the Second Directive is to establish the subscribed capital as the credit basis of the company for the protection of creditors, the articles concerning the maintenance of the subscribed capital are as important as those concerning the raising of capital.

Article 15 of the Second Directive is the core of the provisions enacted to maintain subscribed capital. Payments to shareholders of dividends and interest relating to shares, and the permission to acquire its own shares and redemptions[75] are subject to the following test, which is similar to the "Balance Sheet Surplus Test":

> Except for cases of reductions of subscribed capital, no distribution to shareholders may be made when on the closing date of the last financial year the next assets as set out in the company's annual account are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes.[76]

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71. Second Council Directive, *supra* note 3, art. 6.2 and 6.3.

72. Second Council Directive, *supra* note 3, art. 9; The reason behind this rule is to avoid unneeded assets in the corporation. In the beginning there is often no need for all the money (or other assets) promised by the shareholders. The "unused" money would be a (temporary) negative investment. *See*, J. RONSE, ALGEMEEN DEEL VAN HET VENNOOTSCHAPSRECHT, 306 (Leuven, 1975); Y. GUYON, *supra* note 69, at 271.

73. Second Council Directive, *supra* note 3, art. 7. In the United States most courts and statutes have imposed a similar prohibition. An agreement for future services is not acceptable as a medium of payment to discharge the pay- in obligation of the shareholders. B. MANNING, *supra* note 1, at 41.

74. In the United States, the board of directors has the responsibility for determining the value of contributions in kind. According to most statutes their determination is (in the absence of fraud) conclusive and determinative. B. MANNING, *supra* note 1, at 44; Yates, III, *supra* note 4, at 119.

75. Second Council Directive, *supra* note 3, arts. 15.1(d), 19.1(c), 35(b), 39(d).

76. *See supra* notes 30-32 and accompanying text.

Payments to shareholders of dividends and interest relating to shares and redemptions are subject to a second test which is similar to the "Earned Surplus Test":[77]

> The amount of a distribution to shareholders may not exceed the amount of the profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed on reserve in accordance with the law or the statutes.[78]

The directives contain many other detailed provisions on the withdrawal of shares by purchase or redemption (for those Member States where this is allowed), the reduction of subscribed capital and the maintenance of subscribed capital in general.[79] Most of these are worth mentioning in order to give a more complete view of the provisions.

Article 17 of the Second Directive provides that the case of a serious loss of the subscribed capital must give rise to a general meeting of shareholders. The shareholders at this general meeting must then consider whether the company should be wound up or whether other measures should be taken.[80]

Article 30 of the Second Directive provides that a reduction in the subscribed capital must normally take place by a two-thirds majority vote of the shareholders in a general meeting.[81] The creditors whose claims antedate the publication of the decision to make the reduction shall be entitled to have the right to obtain security for claims which have not fallen due at that time, if the reduction is due to over-capitalization.[82] If the reduction is to offset losses incurred, or to include sums of money in a reserve (maximum ten percent of the reduced subscribed capital) the amounts derived from the reduction may not be used for making payments or distributions to shareholders or discharging them from the obligation to make their contributions.[83] Article 34 of the Second Directive provides that the subscribed capital may not be reduced to an amount less than the minimum capital.

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77. Second Council Directive, *supra* note 3, arts. 15.1(d), 35(b), 39(d).

78. *See supra* notes 30-32 and accompanying text. *See also* van Hulle, *Wettelijke beperkingen inzake winstuitkering - Limitations lègales en matière de distribution des bênéficres*, in LA MODIFICATION BELGE, *supra* note 66, at 31, and Hackney, *supra* note 33, at 1363-1366 for a comparison of this test and the balance sheet surplus test.

79. Schmitthoff, *supra* note 62, at 51; *See also* Second Council Directive, *supra* note 3, arts. 18-42.

80. *See* Debrulle, *La responsabilité des administreurs en cas de perte grave du capital*, in LA MODIFICATION BELGE, *supra* note 66 at 105.

81. The notice concerning the meeting must specify at least the purpose of reduction and the way in which it is to be carried out. Second Council Directive, *supra* note 3, art. 30.

82. *Id.* arts. 32, 33.1.

83. *Id.* art. 33.2. This dichotomy finds its origin in the legal systems of Germany (Wooldridge, *supra* note 57, at 340), the United Kingdom (Id. at 340 and Morse, *supra* note 4, at 131) and French law concerning commercial companies, art. 216; AKtG, art. 229; Companies Act 1948, § 67.

C. *Other Rules Governing Distributions*

Under Articles 34.1(b) and 37 of the Fourth Council Directive, a corporation may not distribute dividends if the corporation has, where authorized by national law, included organization expenses or expenses of research and development under 'assets,' unless these expenses have been completely written off, or if the amount of the reserves available for distribution and profits brought forward is at least equal to that of the expenses not written off.[84]

In the United States, General Accepted Accounting Principles (GAAP)[85] prescribe that expenses for research and development have to be deducted at once and must not be recorded as assets.[86] Organization expenses, however, may generally be carried as assets written off as expenses over a period not to exceed forty years.[87]

Some countries have national provisions which go further than the minimum requirements of the Directives, for example, higher minimum capitalization requirements. Other countries have imposed liability where the corporation was undercapitalized. For example, article 35.6 of the Belgian Consolidated Laws on Companies, assesses liability to the founding shareholders in the event of bankruptcy within three years of the incorporation, if the capital was obviously insufficient to cover the proposed activities of the corporation for an initial period of at least two years. The judge will generally base his decision on a financial forecast furnished by the founding shareholders to the notary at the time of incorporation.[88]

IV. THE "CUSHION" OR "TRUST FUND" DOCTRINE

In many E.E.C. countries the requirements for minimum capital as a

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84. Fourth Council Directive of 25 July 1978 based on Article 54 (3)(g) of the Treaty, on the annual accounts of certain types of companies, 21 O.J. EUR. COMM. No L 222, 11 (1978) [hereinafter cited as Fourth Council Directive]. After implementation of the E.E.C.-Directives these provisions and the provisions provided by the Second Council Directive are part of article 77bis of the Belgian Consolidated Laws on Companies. *See* van Hulle, *Wettelijke bescherming inzake winstuitkering - Limitations légales en matière de distribution des bénéfices*, in LA MODIFICATION BELGE, *supra* note 66, at 82.

85. General Accepted Accounting Principles [hereinafter referred to as GAAP] consist of partially codified accepted practices of the accounting profession. The GAAP can be found in the practice of the profession itself and in a collection of definitive publications, *e.g.* by the American Institute of Certified Public Accounts (AICPA) and the Financial Accounting Standard Board (FASB). *See* S. SIEGEL & D. SIEGEL, *supra* note 12, at 6-7; T. FIFLIS, *supra* note 7, at 82-99.

86. Statement of Financial Accounting No. 2, Accounting for Research and Development Costs, ¶ 12 (FASB, 1974).

87. *See* T. FIFLIS, *supra* note 7, at 258-259, 270; S. SIEGEL & D. SIEGEL, *supra* note 12, at 71-72.

88. *See generally* Wymeersch, *Oprichtersaansprakelijkheid bij inbreng van financieel negatief vennootschapsvermogen*, 22 RECHTSKUNDIG WEEKBLAD 2129, 2129-2146 (1979); Breesch, *Oprichting van N.V.'s en P.V.B.A.'s: enige cijfers en bedenkingen*, 24 RECHTSKUNDIG WEEKBLAD 1625-1656 (1981).

trust fund for general creditors have been increased by the implementation of the Directives. The idea of minimum capitalization has been completely abolished in the MBCA. This author suggests that a trust fund is necessary for the protection of general creditors and that while some of the existing solutions are promising, they all have defects. The use of financial ratio tests is proposed as a better solution. Economic matters, including valuation issues, however, must still be taken into consideration when fixing the applicable ratios.

A. *The Doctrine*

The principal object of the legal capital systems in the United States, as well as in the E.E.C., is to afford a margin of protection for creditors,[89] in view of the limited liability of the shareholders.[90] While most financial or institutional creditors can protect themselves against insolvent debtors,[91] general trade creditors cannot, as a practical matter, similarly protect themselves.[92]

Provisions for the raising and maintenance of minimum capital can protect creditors by reducing the probability of insolvency or bankruptcy, and minimizing creditors' losses if either occurs.[93] The theory behind the idea of capital as protection for shareholders is the "trust fund" or "cushion" doctrine.

The trust fund doctrine finds its origin in *Wood v. Dummer*.[94] The court in *Drummer* held that shareholders who received liquidating distributions from an insolvent bank had to return these corporate assets for distribution to their creditors, because the shareholders' equity is a "trust fund" for creditors, and distributions out of capital were therefore illegal. Justice Story stated:

> The individual stockholders are not liable for the debts of the bank in their private capacities. The charter relieves them from personal re-

89. Dividend regulations often include some protection of other parties: Either of the shareholders against a diminution of their investment, or of one class of shareholders against another. B. MANNING, *supra* note 1, at 73; Hackney, *supra* note 33, at 1365; Task Force Report, *supra* note 28, at 303.

90. Ralston, *supra* note 7, at 1019; T. FIFLIS, *supra* note 7, at 524; Task Force Report, *supra* note 28, at 303; Ackerman, Jr., Sterrett II, *supra* note 43, at 1052; Ronse, *Kapitaalbescherming bij de oprichting van de N.V.*, in DORHOUT MEES COLLECTION, VERZEKERING VAN VRIENDSCHAP, RECHTSGELEERDE OPSTELLEN AANGEBODEN AAN PROF. MR. T.J. DORHOUT MEES, 183, 184-185 (1974); Tunc, *A French Lawyer Looks at American Corporation Law and Securities Regulations*, 130 U. PA. L. REV. 757, 764-768 (1982); Yates, III, *supra* note 4, at 118-119; Schmitthoff, *supra* note 62, at 48; Guyon, *supra* note 66, at No. 7.

91. *E.g.* by mortgage of real estate, pledge of securities or contractual limitations. *See* B. MANNING, *supra* note 1, at 94-107.

92. Marsh, Jr., *Introduction, Symposium, The New California General Corporation Law*, 23 UCLA L. REV. 1035, 1045 (1976); B. MANNING, *supra* note 1, at 91-94.

93. Gibson, *Surplus So What? The Model Act Modernized*, 17 BUS. LAW. 476, 485 (1962).

94. 30 F. Cas 435 (C.C.D.Me. 1824) (No. 17, 944).

> sponsibility, and substitutes the capital stock in its stead . . . . If the stock may, the next day after it is paid in, be withdrawn by the stockholders without payment of the debts of the corporation, why is its amount so studiously provided for, and its payment by the stockholders so diligently required?. . . . They [the stockholders] have the full benefit of all the profits made by the establishment, and cannot take any portion of the fund, until all the other claims on it are extinguished.[95]

Many states have enacted provisions which are premised on this theory to protect creditors by limiting corporate distributions to shareholders by means of legal capital systems.[96]

B. *General Evaluation of the Trust Fund Theory*

For many years criticism has been directed against legal capital systems.[97] The recent changes in the California General Corporation Code and in the MBCA,[98] were adopted because the general restrictions based on legal capital were judged not to serve the original purpose of protecting creditors, particularly general trade creditors.[99] The MBCA has reacted against the perceived malfunctioning of the statutory system by abolishing most of it.[100] A study of the criticism against the old statutory systems in the light of the new MBCA is helpful in evaluating the new provisions.

A criticism often mentioned is that legal capital does not refer to any assets which the corporation actually owns as of the date of the balance sheet. Rather, it refers to an abstract number that is obtained by multiplying the number of shares by the par value of each share, or in the case of no par stock, to the number "stated" by the Board of Directors.[101] Because this number is unrelated to any economic facts relevant to creditors, creditors prefer to rely on the assets and future prospects of the

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95. *Id.* at 436.

96. Siegel, *Accounting and Inflation: An Analysis and a Proposal*, 29 UCLA L. REV. 271, 318-319 (1982); Ralston, *supra* note 7, at 1021 and 1025; T. FIFLIS, *supra* note 7, at 432; *See supra* notes 6-55 and accompanying text. In Europe, as well, capital is seen as a fixed and "intangible" cushion for the protection of creditors. Tunc, *supra* note 90 at 768; J. RONSE, *supra* note 72, at 299; Ronse, *supra* note 90, at 185-186; Massagé, *Capital social et opérations financières - Maatschappelijk kapitaal en financiele verrichtingen*, in LA MODIFICATION BELGE, *supra* note 66, at 53, 54; Guyon, *supra* note 66, at n. 7. *See supra* notes 62-87 and accompanying text.

97. For a historical example, see Ballentine & Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws*, 23 CALIF. L. REV. 229, 258 (1935). It is important to distinguish between the trust fund doctrine and different systems which are often seen as implementations of the trust fund doctrine in corporation law.

98. *See supra* notes 40-55 and accompanying text.

99. Report of the Assembly Select Committee on the Revision of the Corporations Code, 71 (1975); *Amendments*, *supra* note 5, at 1867.

100. *See supra* notes 48-49 and accompanying text.

101. *See supra* notes 8-39 and accompanying text. B. MANNING, *supra* note 1, at 30; Cohn, *supra* note 6, at 574; Ralston, *supra* note 7, at 1021.

corporation as reflected by the entire range of information shown on contemporary balance sheets and income statements.[102]

Legal capital on the balance sheet is not intended to show the amount of the assets available to creditors. Rather, legal capital indicates the assets which may not be distributed to shareholders. These assets can only "leave" the company due to losses and they must be restored after losses have been incurred before any distribution of assets to the shareholders may take place.[103] In fact it may be argued convincingly that creditors do not look to capital accounts because the statutory legal capital systems are not efficient in raising and maintaining legal capital as a trust fund large enough to protect creditors. This deficiency is another reason why the "old" systems has been criticized.

The lack of independent valuation of capital contributions in kind,[104] the possibility of reducing stated capital by several devices (without approval of the creditors or without giving them any other protection),[105] the allowance of nimble dividends[106] and the lack of any meaningful minimum required capital[107] are generally seen as major deficiencies of the existing statutory legal capital systems.

In Europe these issues are resolved by requiring a valuation report for capital contributions in kind (by one or more independent officially approved experts), by limiting reductions of capital by severe rules, or by forbidding any "nimble" dividends and requiring a minimum initial capitalization. In contrast, the MBCA has opted for the abolition of everything that has some connection with legal capital, including the existence of any trust fund for creditors.[108] In one sweeping revision, the MBCA thereby dealt with the often criticised complexity of the statutory legal capital systems.[109] Consequently, under the MBCA more "economically sensible transactions"[110] can be lawfully consummated than under the various statutory legal capital systems.

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102. B. MANNING, *supra* note 1, at 85; Cohn, *supra* note 6, at 575; Ralston, *supra* note 7, at 1026.

103. *See supra* notes 26, 75-78 and accompanying text. *See also* Siegel, *supra* note 96, at 320.

104. *See supra* note 74 and accompanying text.

105. B. MANNING, *supra* note 1, at 86; Cohn, *supra* note 6, at 575; R. HAMILTON, *supra* note 7, at 108; *See supra* notes 38, 83 and accompanying text.

106. B. MANNING, *supra* note 1, at 86; T. FIFLIS, *supra* note 7, at 434; Hackney, *supra* note 24, at 800; *See supra* note 39 and accompanying text.

107. *See supra* notes 21-22 and accompanying text; Dreyfuss, *supra* note 43, at 840.

108. One could argue that if the assets of the corporation have a higher value (*e.g.* the liquidation or market value) than the value used to determine the legality of dividends (*e.g.* the book value), the difference between the two "values" constitutes a trust fund for creditors. The opposite is true as well. All depend on the valuation methods used. Even if a cushion exists in some cases under the MBCA, it doesn't appear to have been the purpose of the drafters.

109. *See* B. MANNING, *supra* note 1, at 86.

110. *Id.* at 88.

Nevertheless, the MBCA did not abolish all deficiencies.[111] As in the legal capital systems, the decision power concerning distributions is still in the hands of the board of directors which is elected by the shareholders.[112] For important issues concerning the valuation of assets and accounting principles used in order to prepare the balance which is the basis of the "balance sheet test," no clear rules are provided.[113]

One commentator made the following cogent remarks about the "old" systems:

> The most persuasive evidence of the quintessential triviality of the system, however, lies in the fact that any corporation lawyer of moderate skill can nearly always arrange things . . . so as to make a lawful shareholder distribution so long as insolvency is not the immediate consequence.[114]

The MBCA has, by lowering the standards for legal distributions to shareholders, made easier what already was possible (often after some expense) in some ineffective statutory legal capital systems. The dual insolvency test of the MBCA has the merit of simplicity. However, by prohibiting distributions where the ratio between total assets and total liabilities is lower than one to one, the test is more likely to ascertain, than to predict insolvency (equitable or bankruptcy) as a consequence of the distribution.[115]

The Uniform Fraudulent Conveyances Act[116] will often provide better protection for creditors than the MBCA. While the MBCA is not specific about the method to be used to value the assets,[117] the UFCA determines the value of assets as the present fair saleable value.[118] If the assets have a lesser value under the UFCA method, than by a calculation method under the MBCA then there can be "legal distributions" that are "illegal conveyances" according to the UFCA.[119]

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111. Some of them are issues in any known system regulating distributions to shareholders.

112. B. MANNING, *supra* note 1, at 85 and 87; R. HAMILTON, *supra* note 7, at 108; Marsh, Jr, *supra* note 91, at 1044.

113. *See infra* notes 139-160 and accompanying text.

114. B. MANNING, *supra* note 1, at 87.

115. The two tests of the MBCA are more useful as a tool for litigation than as a means for planning. R. JENNINGS & R. BUXBAUM, CORPORATIONS, 922 (5th ed. 1979); Ben-Dror, *supra* note 41, at 381 and 395.

116. Unif. Fraudulent Conveyances Act, 74 U.L.A. 41 (1985) [hereinafter referred to as UFCA], has been enacted in 26 states. The UFCA enables the trustee to recapture in some circumstances for the benefit of creditors, funds distributed by debtors to others (*e.g.* shareholders). *See* Clark, *supra* note 2, at 505; Kummert, *supra* note 1, at 271-275.

117. *See infra* 154-159 and accompanying notes.

118. UFCA *supra* note 116, § 2(1). The UFCA has no provision for liability of directors. In contrast, the MBCA provides liability of directors in § 48. Does this difference justify the application of different standards? *See also Amendments*, *supra* note 5, at 1882-1883; REVISED MODEL BUSINESS CORP. ACT 124 (1985), and R. JORDAN, W. WARREN, BANKRUPTCY, CASES, MATERIALS AND PROBLEMS, 337-343 (unpublished, 1984).

119. The issue of accounting principles used, is extremely important in all systems reg-

A trust fund is a *conditio sine qua non* for a serious and fair protection of creditors. A study has shown that even if a trust fund of twenty-five percent of all the liabilities is required, many corporations can still legally distribute assets to their shareholders one year prior to bankruptcy.[120]

Efficient rules for the raising and maintenance of a trust fund are much more complex than the provisions of the MBCA. The European system and the many complex rstrictive covenants imposed by finance and institutional creditors[121] provide better protection for creditors than the MBCA. The simplicity of the MBCA should not prevail over the fairness and efficient protection brought by more elaborate solutions.

Whatever the capital is at incorporation, this amount should never be paid to shareholders without the approval of creditors or without giving them security to protect their claims.[122] Even if the creditors get security or approve distributions out of capital[123] to shareholders, the law should require a minimum capital to be maintained in all cases in order to protect future creditors. The same minimum amount should also be required as a minimum initial capitalization before commencing activity in corporate form. This requirement will provide a cushion for creditors during the lifetime of the corporation. If the rules for the raising and maintenance of this amount are efficient, the available protection will be largely determined by the amount or ratio required as minimum capitalization.

C. *The Arbitrariness of the Trust Fund*

The American statutory legal systems and the European corporation laws have almost always required a fixed amount as minimal capitalization.[124] The very low minimal capital requirement or the absense of any requirement at all in the United States,[125] is based on the notion that the "old" statutes are seen as mere enabling acts, with no regulatory function.[126] In the early 1900s, courts came to deny limited liability to shareholders if no reasonable amount of capital was in fact provided for the

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ulating corporate distributions to shareholders.

120. Ben-Dror, *supra* note 41, at 395.

121. W. KLEIN, BUSINESS ORGANIZATION AND FINANCE, LEGAL AND ECONOMIC PRINCIPLES 160-166 (1980); B. MANNING, *supra* note 1, at 105-106; *See supra* note 91 and accompanying text. Creditors often require that businesses be financed with a large enough equity cushion (W. KLEIN, *supra*, at 49) or satisfy financial ratios (Ballantine & Hills, *supra* note 97, at 259).

122. *See supra* notes 62-83 and accompanying text.

123. It is clear that "distributions out of capital" means distributions of these assets which form the counterpart of the legal capital on the balance sheet, and which cause the total assets of the corporation to be less than the total liabilities *plus* the legal capital.

124. *See supra* notes 21, 68, 69 and accompanying text.

125. *See supra* notes 21 and 23.

126. Katz, *The Philosophy of Midcentury Corporation Statutes*, 23 LAW & CONTEMP. PROBS. 117, 179, 181-183 (1958); Hackney & Benson, *supra* note 15, at 856.

protection of creditors.[127] Undercapitalization became one of the principal factors looked at by the courts as a reason to "pierce the corporate veil."[128] The doctrinal basis for these decisons was the improper use of the corporate form.[129] However, courts do not automatically impose liability for undercapitalization, but often look to equitable factors in determining whether to do so.[130]

The law in this area is generally confused and many questions have no clear answers.[131] There is no assurance of economic viability for newly formed corporate enterprises and courts limit the piercing of the corporate veil to extreme cases,[132] in order to respect the principle of limited liability. Although the concept of undercapitalization is in most cases a difficult tool for corporate planning and protection of creditors, it should be maintained as a device of last resort.

A larger than nominal "fixed" amount of minimal required capitalization, as in Europe, certainly gives better protection to creditors, but the larger the corporation, the less protection a fixed amount will provide. The minimal capital requirement is therefore not an entirely satisfactory solution.

In order to have an efficient rule for small and large corporations, the use of financial ratios should be considered. California was the first state to use a combination of financial ratios as a mechanism for regulating corporate distributions.[133] Under California Corporation Law, a corporation may make distributions in excess of retained earnings if it can meet two financial ratio tests.[134] This test to evaluate the solvency and stability of a corporation[135] is commonly referred to as a "bankruptcy prediction model."[136] Under the California Corporation Code, however, it is still pos-

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127. *See e.g.*, Oriental Inv. Co. v. Barclay, 25 Tex. Civ. App. 543, 64 S.W. 80 (1901).

128. Note, *Inadequate Capitalization as a Basis for Shareholder Liability: The California Approach and a Recommendation*, 45 S. CAL. L. REV. 823, 824 (1972); Hackney & Benson, *supra* note 14, at 854.

129. H. BALLANTINE, BALLANTINE ON CORPORATIONS, § 129 at 302-303 (1946); Hackney & Benson, *supra* note 14, at 854 and 857. Worthwhile to mention here is section 5 of the UFCA (*See supra* note 118), which forbids gratuitous or unfair transfers by a business debtor when the transferor would be left with an unreasonable small capital. This is, however, different from the requirement for initial capitalization. Clark, *supra* note 2, at 540. *See also* Federal Bankruptcy Code, 11 U.S.C. § 548(a)(2)(B)(ii) (1982). These provisions have not been enforced vigorously, and there are only a few cases. Hackney & Benson, *supra* note 14, at 860-861 n.105. *See also* note 88 and accompanying text.

130. Hackney & Benson, *supra* note 14, at 885 and 901; Note, *supra* note 128, at 830.

131. Hackney & Benson, *supra* note 14.

132. B. MANNING, *supra* note 1, at 17-18 n.2. For examples see Hackney & Benson, *supra* note 14, at 891-898.

133. Ben-Dror, *supra* note 41, at 377.

134. *See supra* notes 40-55 and accompanying text. CAL. CORP. CODE § 500(b) (Deering 1977).

135. § 500(b) attempts to predict bankruptcy by using a predictive factor of one quarter into the total assets ratio, *i.e.* total assets 11/4 times total liabilities.

136. Ben-Dror, *supra* note 42, at 376. The fact that these ratio tests only have to be satisfied under California Law for distributions in excess of retained earnings means that no

sible to make distributions of retained earnings, even if the two tests are not met. Corporate assets can still be distributed to shareholders without leaving a trust fund for present and future creditors, as long as the distributions consist of earnings. Protection for general creditors against distribution of assets, whether made out of earnings or not, has to be conditional on compliance with the financial ratio tests.

The model used should be applicable to all corporations, regardless of size or industry. The most efficient ratio of capital versus leverage (liabilities), however, depends on many factors, such as the industry characteristics, the growth rate and stability of sales, the assets structure, management and lenders attitudes.[137] It would be too complex to provide different rules for different sizes or kinds of industries. In order to enhance the practical application, a simple standard model is preferable. Simplicity, high prediction rates and low overprediction rates should be taken into account according to their respective importance. The requirement of a fixed minimum capitalization,[138] the use of a bankruptcy prediction model, and as a last resort, the doctrine of misuse of the corporate entity, provides a better standard for shareholders, directors and creditors than any existing system.

D. *Valuation Issues*

Regardless of which requirements or tests regulating corporate distributions are imposed by law, no system will provide a clear rule if there are no provisions concerning the definition and methods for the valuation of assets.[139] There are different valuation methods that have different effects on the amount of protection available for creditors.[140] Many states use the term "assets," but most do not resolve the fundamental question of their valuation. Moreover, courts offer little guidance in the valuation

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financial solvency has to be present to pay distributions out of retained earnings. *See* CAL CORP. CODE § 500(a) (Deering 1977). The requirements of §500(a) and (b) should be cumulative instead of alternative.

137. *See* J. WESTON & T. COPELAND, MANAGERIAL FINANCE, ch. 20 (8th ed. 1985). The California Corporation Code ratio of assets 11/4 times liabilities could give problems in industries where high leverage is common and economically sensible.

138. A fixed amount should be maintained in order to avoid that big risks are taken by very small "corporations" that fulfill the tests, but have no reasonable trust fund available to cover losses.

139. *See* B. MANNING, *supra* note 1, at 62; Hackney, *supra* note 24, at 801; Hackney, *supra* note 33, at 1371.

140. Different "values" include: liquidating value, going concern value, book value, market value, fair or reasonable value. *See* J. WESTON & T.COPELAND, *supra* note 137, ch. 23. For example, if the book value of the assets is smaller than their going concern value (*e.g.* because fast depreciation is allowed), creditors are better protected when the book value is used to determine the minimal capital requirements, than when the going concern value would be used. In the latter case, creditors would have only a little cushion or none at all if the corporation were forced to liquidate, because the liquidating value often is smaller than the going concern value.

of assets.[141]

Searching for clear and detailed rules on the valuation of assets, authors have often referred to GAAP[142] for general guidance.[143] Yet, because GAAP often provides a choice of method, it gives no guarantee of certainty in financial determinations.[144]

GAAP, however, is much more clear than the "old" laws which, in requiring that financial statements be made in a reasonable manner, leave resolution of accounting matters to judgment under a common law of uncertain content and application.[145] Another important advantage of GAAP is its continuous adaptation in response to changes in economic and social conditions, new knowledge and technology, and to demands of users for more serviceable financial information.[146]

Some states have taken a step to provide better protection for creditors by requiring valuation of assets according to GAAP.[147] In Europe, similar considerations supported the enactment of the Fourth Council Directive on the annual accounts of limited liability companies.[148] The Fourth Council Directive contains detailed instruction on valuation methods in section seven which is entitled "valuation rules."[149] The Directive also establishes a "contact committee" which will facilitate the harmonized application of the Directive and advise the European Commission

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141. B. MANNING, *supra* note 1, at 62; S. SIEGEL & D. SIEGEL, *supra* note 12, at 99; Siegel, *supra* note 96, at 319-320; Ballantine & Hills, *supra* note 97, at 259. It is a very difficult task for a legislature or a court to establish principles for the valuation of assets. Hackney, *Corporate Law Aspects of Some Recent Developments in Accounting*, 3 J. L. & COM. 1 (1983).

142. *See supra* note 85.

143. Siegel, A Critical Examination of State Regulation of Accounting Principles, (unpublished, 1985); B. MANNING, *supra* note 1, at 61-62; Hackney, *supra* note 24, at 797 and 823.

144. Ackerman, Jr., *supra* note 43, at 1080.

145. *Id.*; Siegel, *supra* note 96, at 321-322.

146. APB No. 4, ch. 9, ¶¶ 2-3 (1970).

147. *See e.g. North Carolina* (N.C. GEN. STAT. §§ 55-2(2), 55-49(b)(1982), *Michigan* (Mich. Comp. Laws. Ann. § 450.1110 (1973), *Maryland* (MD. CORP. & ASSNS CODE ANN. § 1-402 (1982), *California* (CAL. CORP. CODE § 114 (Deering (1977)). B. MANNING, *supra* note 1 at 62 n.7; S. SIEGEL & D. SIEGEL, *supra* note 12, at 99; Task Force Report, *supra* note 28, at 294; Dreyfuss, *supra* note 43, at 845; Ackerman, Jr., *supra* note 43, at 1065, 1081; Siegel, *supra* note 96, at 319 n.156; Hackney, *supra* note 141, at 12. Siegel, *supra* note 143, n.6.

148. *See supra* note 85. "Whereas the coordination of national provisions concerning the presentation and content of annual accounts and annual reports, *the valuation methods used therein* and their publication in respect to certain companies with limited liability is of *special importance for the protection of* members and *third parties*." (emphasis added) Statement of legislative purpose, Fourth Council Directive, *supra* note 85. For an overview of all "accounting directives" (Fourth; Seventh, adopted 13 June 1983, and Eighth, adopted 13 March 1984), see van Hulle, *The EEC Accounting Directives in Perspective: Problems of Harmonization*, 18 COMM. MKT. L. REV.121 (1981); Schneebaum, *supra* note 57, at 305-307 and 310-317; Nieuwdorp, *supra* note 60, at 426-430.

149. Fourth Council Directive, *supra* note 84, art. 31-42. Schneebaum, *supra* note 57, at 306.

on additions or amendments to the Directive[150] in order to follow accountancy developments in Member States.[151]

Section 6.40(d) of the new MBCA provides that determinations of corporate assets may be based upon financial statements prepared on the basis of accounting practices and principles of a fair valuation or any other method that is reasonable in the circumstances.[152] While these "reasonable" principles are not necessarily consistent with GAAP,[153] the drafters expect that their use will be the basic rule in most cases.[154] The statutory language, however, requires an informed business judgment in the choice of the accounting principles used,[155] and commentary to the Revised MBCA suggests that, in most cases, "going concern" value would be the appropriate method in determining the value of the assets.[156]

These "guidelines" are of little help to directors, and the commentary by the drafters of the MBCA makes quite clear they are not intended to constitute a safe harbor for them.[157] The broad business judgment rule on the other hand provides little protection for creditors.[158] Directors and creditors would be better off if state laws provided a safe harbor for directors consisting of a dividend test exercised in good faith reliance on financial statements prepared in conformity with GAAP.[159] An informed business judgment should only be required if the GAAP provide an important choice or if no solution for a specific problem is given.

V. CONCLUSION

The comparative overview and analysis of the United States and

150. Fourth Council Directive, *supra* note 84, art. 52.

151. van Hulle, *supra* note 148, at 129. For the development of the Belgian accounting law, see de Lembre, *Boekhoudrecht in Belgie: ontstaan en evolutie*, 16 TIJDSCHRIFT VOOR PRIVAATRECHT 401, 401-437 (1979); Lemaître, *Réforme de la comptabilité et des comptes annuels des enterprises belges*, 34 REVUE TRIMESTRIELLE DE DROIT COMMERCIALE 627, 627-680 (1981); van Crombrugge, *Boekhoudrecht en boekhoudtheorie*, 18 TIJDSCHRIFT VOOR PRIVAATRECHT 973, 973-1021 (1981).

152. For a more extensive discussion of these provisions of the MBCA, *see* Siegel, *supra* note 143, nn.28-32 and accompanying text.

153. Goldstein & Hamilton, *The Revised Model Business Corporations Act*, 38 BUS. LAW. 1019, 1021 (1983).

154. REVISED MODEL BUSINESS CORP. ACT § 6.40(d) (1985).

155. *Id.*

156. *Amendments, supra* note 5, at 1885.

157. *Id.* at 1884; Task Force Report, *supra* note 28, at 301.

158. Problems arise in connection with goodwill and reappraisal of fixed assets as factors taken in account by the directors in determining the legality of dividends. Cohn, *supra* note 6, at 577.

159. *See* Siegel, *supra* note 143, 17-20. *See also* Task force report, *supra* note 28, at 302-303; Hackney, *supra* note 141, at 32-34. In Belgium, accounts prepared according to "general accepted accounting principles" (similar in many aspects to the GAAP of the U.S.A.), provide a safe harbor for directors by creating the presumption that they give a true and fair view of the corporation's financial situation. *See* van Crombrugge, *supra* note 151, at 998-999.

E.E.C. financial provisions concerning distributions to shareholders has shown that none of the existing systems provide sufficient protection to general creditors of a corporation. The best way to achieve reliable protection is to provide a system which combines a fixed minimum capitalization (which should be high enough to give at least some protection by itself) and the use of a financial ratio test (bankruptcy prediction model). All distributions would have to be made subject to the minimum capitalization requirement and the financial ratio tests, even if the distributions are earnings. Those earnings which may not be legally distributed under the system will create a solid trust fund in case of thin initial capitalization.

Because there are different ways to value an asset, the proposed system can only be made efficient by enactment or referral to detailed accounting principles for their valuation. While the E.E.C. countries have chosen to enact accounting principles through the Seventh Directive, a referral to the GAAP could fulfill this task in the United States.

The E.E.C. countries should improve their systems by enactment of financial ratios as dividend tests. The existing system of minimum capitalization only provides protection to general creditors of small corporations. Financial ratio tests will provide adequate protection to creditors of large corporations as well.

In the United States, the new MBCA has made a step in the right direction by eliminating some outmoded concepts and adopting a financial ratio test. The assets-liability ratio requirement of one to one, and the absence of detailed accountancy rules certainly diminished the complexity of the dividend regulating system. Unfortunately, the MBCA also brought protection for general creditors down to a meaningless level. Nevertheless, the revisers of the MBCA are in a perfect position to adopt the proposed solution. The proposed system probably will be more complex than today's MBCA, but in these matters, simplicity should not prevail over efficiency.