University of Richmond Law Review

Volume 15 | Issue 4 Article 5

1981

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EQUITY INSOLVENCY AND THE NEW MODEL BUSINESS CORPORATION ACT

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I. Revisions to Financial Provisions of the Model Act

A. *Overview*

One consequence of the recent and far-reaching revisions to the financial provisions of the Model Business Corporation Act (hereafter the "Model Act")[1] is to re-focus attention on the significance of the elusive concept of equity insolvency as it affects corporate distributions.

Briefly, these revisions to the Model Act eliminate all of the accounting definitions including stated capital, surplus, and earned surplus from old section 2;[2] make par value optional and of no substantive effect;[3] and eliminate the concepts of treasury shares, redemption and cancellation of shares, and reduction of stated capital. Central to the scheme set out in the amendments is a new section 45 which authorizes extremely liberal distributions[4] to

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1. Model Bus. Corp. Act Ann. 2d (1971) (rev. 1980). In this article, reference to the text of new sections is based upon *Changes in the Model Business Corporation Act—Amendments to Financial Provisions, A Report of Committee on Corporate Laws*, 34 Bus. Law. 1867 (1979) [hereinafter cited as *Changes*]. The text appearing in *Changes* was approved in 1980. *Changes in the Model Business Corporation Act—Amendments to Financial Provisions, A Report of Committee on Corporate Laws*, 35 Bus. Law. 1365 (1980).

Throughout this article, the version of the Model Act sections as revised by these amendments is referred to as "new Model Act" or to a "new section" thereof and the version of the sections as they existed prior to the amendments and as contained in Model Bus. Corp. Act Ann. 2d (1971) is referred to as "old Model Act" or to an "old section" thereof.

2. For a critique of old § 2 accounting definitions, see Garrett, *Capital and Surplus Under the New Corporation Statutes*, 23 L. & Contemp. Prob. 239 (1958); Gibson, *Surplus, So What?*, 17 Bus. Law. 476 (1962); Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 Harv. L. Rev. 1357 (1957); Seward, *Earnest Surplus—Its Meaning and Use in the Model Busiess Corporation Act*, 38 Va. L. Rev. 435 (1952).

3. Par value may still be useful as a means of identifying various classes of shares.

4. A "distribution" is defined in new § 2(i) as:

shareholders. Substantively, this section makes the accounting definitions, par value, redemption of shares and reduction of stated capital obsolete; consequently they are eliminated.[5]

New section 45 states the circumstances in which a corporation may make a distribution to its shareholders. It thereby replaces old sections 45, 46 and 66, which dealt respectively with dividends, distribution from capital surplus and redemption of shares. Under new section 45, a corporation is authorized to make any distribution to its shareholders with the exception that:

> [N]o distribution may be made if, after giving effect thereto, either:
> (a) the corporation would be unable to pay its debts as they become due in the usual course of its business; or
> (b) the corporation's total assets would be less than the sum of its total liabilities and (unless the articles of incorporation otherwise permit) the maximum amount that then would be payable, in any liquidation, in respect of all outstanding shares having preferential rights in liquidation.
>
> Determinations under subparagraph (b) may be based upon (i) financial statements prepared on the basis of accounting practices and principles that are reasonabble in the circumstances, or (ii) a fair valuation or other method that is reasonable in the circumstances.
>
> In the case of a purchase, redemption or other acquisition of a corporation's shares, the effect of a distribution shall be measured as of the date money or other property is transferred or debt is incurred by the corporation, or as of the date the shareholder ceases to be a shareholder of the corporation with respect to such shares, whichever is earlier. In all other cases, the effect of a distribution shall be measured as of the date of its authorization if payment occurs 120 days or less following the date of authorization, or as of the

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> a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness, by a corporation to or for the benefit of any of its shareholders in respect of any of its shares, whether by dividend or by purchase, redemption or other acquisition of its shares, or otherwise.

Changes, supra note 1, at 1869.

5. The scheme of distributions established by new § 45 does not necessitate the elimination of treasury shares. They were eliminated because of the perceptions that treasury shares had no meaningful role in view of the accounting changes. *Changes, supra* note 1, at 1869. Treasury shares have been a controversial aspect of the Model Act. *See* Hackney, *supra* note 2, at 1392-402. This was no doubt an additional consideration causing their elimination.

date of payment if payment occurs more than 120 days following the date of authorization.[6]

Earned surplus and capital surplus are eliminated by new section 45 as the sources of dividends and general share repurchases,[7] as is the financial cushion provided by stated capital. Under the old Model Act scheme the amount of the consideration contributed by the shareholders and allocated to stated capital was permanently committed to the corporation. It was unavailable for dividends or share repurchases generally. Thus this amount was an additional cushion for the benefit of creditors and senior shareholders to assure full payment of the obligations owed them.[8] In contrast, under new section 45 any amount up to the full amount of the shareholders' equity, which under the old Model Act was reflected in stated capital, capital surplus and earned surplus, may be paid to the shareholders at any time at the discretion of the board of directors so long as the two tests, equity solvency and the rough equivalent of balance sheet or bankruptcy solvency, are met.[9] The old Model Act was not only more restrictive, but it imposed affirmative restraints. Dividends and share repurchases were affirmatively authorized only from the designated sources and then only if the equity solvency test was met. New section 45 lifts the restrictions and allows any distribution so long as the two tests are met.

This significant change in both emphasis and substance was made because it was perceived that the notions of par value and stated capital, upon which the classic concepts of legal capital were based, "did not today serve the original purpose of protecting creditors and senior security holders from payments to junior security

6. *Changes, supra* note 1, at 1872.

7. Old § 6 authorized the reacquisition of shares from unrestricted and unreserved earned surplus and, if authorized by the articles of incorporation or a majority vote of the shareholders, from unrestricted and unreserved capital surplus.

8. Stated capital could be used even under the old Model Act scheme, however, to effect the four exceptional transactions stated in old § 6. For a succinct treatment of the workings of the accounting concepts and the role of stated capital, see B. MANNING, LEGAL CAPITAL (2d ed. 1981).

9. The two tests are joined by the disjunctive "or." One might be tempted on first reading to conclude that therefore only one or the other need be met. When the tests are read in conjunction with the preamble, it is clear that the section means that a distribution cannot be made if thereafter either equity or balance sheet insolvency would result.

holders."[10] Indeed, these concepts have been criticized on the grounds that creditors rely, not on any accounting cushion, but on the financial strength of the corporation as demonstrated by its financial statements.[11] While these revisions may have the salutary effects of conforming the statute to realistic financial practice, and of eliminating artificial, formal concepts, the safeguards which they do provide must be closely examined.

B. *Limitations on Distributions*

The equity insolvency limitation of new section 45(a) and the balance sheet insolvency limitation of new section 45(b) are the only restrictions in the statute preventing a board of directors from distributing all of the corporation's assets, or all of its shareholders' equity, both its contributed capital and its retained earnings, to the shareholders.

1. Balance Sheet Insolvency

New section 45(b) contains an element which may continue to provide some additional protection for creditors, in the same manner as under the old Model Act. It provides that after any distribution to shareholders total assets, valued on the basis of either historic cost or fair value, must equal liabilities plus the liquidation preference of senior securities. This latter component, the amount of assets equal to the liquidation preference, assures that sums will not be distributed to the junior shareholders at the expense of the senior shareholders, unless expressly authorized by the articles of incorporation. The amount of this liquidation preference does form, however, a somewhat permanent reserve, or cushion, for the benefit of creditors.[12] By the terms of the senior securities, as

10. *Changes, supra* note 1, at 1867 (General Comment). Use of low par stock, with the consideration paid above par being allocated to capital surplus, and the creation of surplus by an amendment to the articles of incorporation to reduce par, were two common devices by which, under the classic notions of legal capital, junior shareholders could be advantaged by dividend or share in repurchase at the expense of creditors or senior shareholders. The protection which the classic concepts purported to afford creditors could thus be ephemeral. *See generally* B. MANNING, *supra* note 8, *passim.*

11. *See, e.g.*, Gibson, *supra* note 2, at 485-86.

12. Old § 46(d) had a similar effect. It prohibited distributions (a term not defined in the old Model Act) from capital surplus if after the distribution net assets (assets minus liabilities) did not at least equal the preferential sum payable on involuntary liquidation. Credi-

stated in the articles of incorporation, this sum generally would be paid to the senior shareholders only when the corporation was liquidated or upon redemption of the shares.[13] Prior to that time the amount would be unavailable to any shareholder and, on liquidation, it would be first available to satisfy the claims of any creditors. However, a distribution to the preferred shareholders by reacquisition of the shares containing this liquidation preference would be permitted even though as a consequence any additional protection provided for creditors by the amount of the liquidation preference would be eliminated. After such a transaction the balance sheet limitation of new section 45(b) would be met so long as there remained as little as a mathematical equivalence of assets to liabilities.[14] Similarly if a corporation had no senior securities with a liquidation preference, new section 45(b) would require only that the value of assets equal the value of the liabilities, after any distribution to shareholders.

A balance sheet insolvency test was unnecessary under the old Model Act. The notion that dividends and general share repurchases could not be made from stated capital served to ensure that distributions not be made which would reduce balance sheet values of assets below that of liabilities plus stated capital. The only qualifications to this proposition were the four exceptional transactions for which old section 6 authorized the use of stated capital.[15] It would be possible for the full amount of stated capital to be paid

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tors were thereby provided with some protection beyond that afforded by the stated capital account. Assets in an amount equal to this preference could be used to satisfy creditors and could not be paid out to the shareholders before creditors were completely satisfied.

Likewise old § 66 prohibited the redemption or purchase of redeemable shares if net assets after the transaction did not at least equal the amount payable to senior or equal rank shares upon involuntary liquidation.

13. The new Model Act would not prevent use of the "redemption" transaction, but only the special accounting consequence accorded by old §§ 6 and 66. Indeed the new statute and the Comment refer to the act of redemption. *See Changes, supra* note 1, at 1872, 1886 (new § 45 and Comment thereto).

14. The old Model Act had a similar effect. If the shares containing the liquidation preference were redeemed, or otherwise reacquired at a price at least equal to the liquidation preference any protection afforded the creditors by the value of the assets equal to the liquidation preference would vanish.

15. Old § 6 lists these as (a) elimination of proportional shares, (b) collecting or compromising indebtedness to the corporation, (c) appraisal rights payments and (d) redeeming or purchasing redeemable shares.

out in these transactions unless to do so would result in equity insolvency. The balance sheet solvency limitation in new section 45 is essentially negative in character. It assures only the equivalency of assets and liabilities. Any deficiency in assets would allow a creditor to seek protection under the bankruptcy act.

2. Equity Solvency

The significance of the equity solvency limitation is thus apparent. It is the only affirmative restraint on distributions to shareholders within the context of the on-going corporation.[16] The drafters of the revisions, the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law, of the American Bar Association, recognized this crucial fact and considered equity solvency "the fundamentally important test."[17]

The Committee attempted to highlight this test by substantively incorporating the notion of equity solvency into new section 45, instead of including it in the definitional section. In fact, the word "insolvency" does not appear in the new Model Act. The substantive language of the test that any corporate distribution is allowed unless "if, after giving effect thereto, . . . the corporation would be unable to pay its debts as they become due in the usual course of its business"[18] is used instead. This language appears only once. Although these changes may emphasize the importance of the test, they certainly do not add a concept not previously contained in the Model Act.

The old version of the Model Act defined insolvency substantially in the same manner as the test set forth in new section 45(a).[19] It also expressly prohibited a corporation from paying divi-

16. It is noteworthy that a form of equity insolvency is a ground for institution of an action under the new bankruptcy code. 11 U.S.C. § 101 (Supp. II 1978). Creditors can commence an involuntary case against a debtor and the court can enter relief if "the debtor is generally not paying such debts as such debts become due . . . ." 11 U.S.C. § 303(h)(i) (Supp. II 1978). *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 323-24 (1977), *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6279-80.

17. *Changes*, *supra* note 1, at 1868.

18. *Id.* at 1872.

19. Old § 2(n) defines insolvency as "[the] inability of a corporation to pay its debts as they become due in the usual course of its business."

dends, or reacquiring or redeeming shares[20] (transactions which are now included within the definition of distribution),[21] while insolvent or which would render it insolvent.[22]

Perhaps the equity insolvency limitation was of less significance under the old Model Act. It was one of two applicable limitations. Earned or capital surplus were the authorized sources from which dividends and share repurchases generally could be effected. The equity insolvency limitation was a separate limitation, on the conclusion of such transactions, independent of the source of funds.[23] Although not necessarily so, as a practical matter it may have been less likely that payment of a dividend, or a share repurchase from earned surplus would violate the separate insolvency limitation. This may have been so because of the permanently dedicated nature of the stated capital. In contrast, the revised version of the Model Act does away with authorized sources of funds to effect corporate transactions.

II. Differing Approaches to Equity Solvency Outside the Model Act

The equity insolvency constraint on corporate distributions as contained in the Model Act is certainly not new. It has been a fun-

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20. Old §§ 45, 46, 6, 66.

21. *Changes, supra* note 1, at 1869 (new § 2(i)). Old § 45 sanctioned payment of cash, property or stock dividends, except where the corporation was insolvent, or when payment would render the corporation insolvent. It is unlikely that a stock dividend could render the corporation insolvent, since no assets were transferred from the corporation. In contrast, the definition of "distribution" in new § 2(i) excludes stock dividends. Thus the limitations of new § 45 are inapplicable to stock dividends or stock splits. *See Changes, supra* note 1, at 1878 (General Comment). Capital surplus was a source for cash as property distributions pursuant to old § 46. Stock dividends were not authorized from capital surplus.

22. Old §§ 45, 46 and 66 are eliminated. New § 6 still authorizes a corporation to reacquire shares of its stock. References to unrestricted and unreserved earned or capital surplus as the source of funds for the reacquisition are deleted, of course, since these concepts have been eliminated. New § 6 does not prohibit share repurchases when the corporation would be rendered insolvent, as did old § 6. The prohibition is unnecessary since share repurchase transactions are included within the definition of the term "distribution." Thus new § 45 applies to such transactions in precisely the same manner as it applies to dividend payments.

23. Old § 45(a) made earned surplus the source for cash or property dividends. Surplus was the source for stock dividends; by definition in old § 2(k), surplus was "net assets minus stated capital," and thus was comprised of both earned and capital surplus.

damental principle of corporate law for years.[24] Moreover, it is also an integral part of the law regarding preferential transfers[25] and appointment of receivers.[26] Indeed, the significant bulk of the cases in which corporate or board of director conduct has been examined to determine if a transaction was concluded while a corporation was, or which rendered it, insolvent are those dealing with preferential transfers and appointment of receivers. Relatively fewer cases deal with the question of whether the same transaction violated the corporation statute.[27]

In some jurisdictions the bankruptcy definition of insolvency is employed for corporate law and preferential transfer purposes.[28] More commonly, however, the equity variant is used for these purposes.[29] The New York statutory definition, "being unable to pay

24. *E.g.*, Ellis v. French Canadian Coop. Ass'n, 189 Mass. 566, 76 N.E. 207 (1905); H. BALLANTINE, CORPORATIONS § 248 (rev. ed. 1946).

25. Ryder Truck Rental, Inc. v. Missouri Beef Packers, Inc., 358 So. 2d 103 (Fla. App. 1978); Berlowe v. Newman, 136 N.J.L. 232, 40 A.2d 812 (1945); Brownstein v. Fiberonics Indus., Inc., 110 N.J. Super. 43, 264 A.2d 262 (1970); First Nat'l Bank of Lyndhurst v. Bianchi & Smith, Inc., 106 N.J. Eq. 333, 150 A. 774 (Ch. 1930).

26. Cincinnati Equip. Co. v. Degnan, 184 F. 834 (6th Cir. 1910); Manning v. Middle States Oil Corp., 15 Del. Ch. 321, 137 A. 79 (1927); Royal Academy of Beauty Culture & Royal Beauty Shop, Inc. v. Wallace, 226 Ind. 383, 78 N.E.2d 32 (1948); Illinois Ref. Co. v. Illinois Oil Co., 130 Okla. 27, 264 P. 904 (1928); Warren v. Porter Const. Co., 29 Wash. 2d 785, 789 P.2d 255 (1948).

27. For cases holding that dividends were prohibited while the corporation was insolvent, *see, e.g.*, United Light & Power Co. v. Grand Rapids Trust Co., 85 F.2d 331 (6th Cir. 1936); Gray v. Sutherland, 124 Cal. App. 2d 280, 268 P.2d 754 (1954). Share repurchases or redemptions have also been prohibited while a corporation was insolvent. *See, e.g.*, Kraft v. Rochambeau Holding Co., 210 Md. 325, 123 A.2d 287 (1956); Williams v. Nevelow, 513 S.W.2d 535 (Tex. 1974). *See generally* H. BALLANTINE, *supra* note 24, at §§ 256-272; W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5324 (rev. ed. 1971) and ch. 63 (rev. ed. 1981); Ballantine & Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws*, 23 CAL. L. REV. 229 (1935); Weiner, *Theory of Anglo-American Dividend Law: American Statutes and Cases*, 29 COLUM. L. REV. 461 (1929).

28. *See, e.g.*, State v. Woodroof, 253 Ala. 620, 46 So. 2d 553 (1950); Zellerbach Paper Co. v. Valley Nat'l Bank, 13 Ariz. App. 431, 477 P.2d 550 (1970); La Voy Supply Co. v. Young, 84 Idaho 120, 364 P.2d 45 (1962); Davies v. Montana Auto Fin. Corp., 86 Mont. 500, 284 P. 267 (1930); Peterson v. John J. Reilly, Inc., 105 N.H. 340, 200 A.2d 21 (1964); Schmitz v. Wisconsin Soap Mfg. Co., 203 Wis. 149, 235 N.W. 409 (1931).

29. *See, e.g.*, Burton v. R.G. Peters Salt & Lumber Co., 190 F. 262 (W.D. Mich. 1911); Manning v. Middle States Oil Corp., 15 Del. Ch. 321, 137 A. 79 (1927); Ryder Truck Rental, Inc. v. Missouri Beef Packers, Inc., 358 So.2d 103 (Fla. App. 1978); Royal Academy of Beauty Culture & Royal Beauty Shop, Inc. v. Wallace, 226 Ind. 383, 78 N.E.2d 32 (1948); Coffman v. Maryland Pub. Co., 167 Md. 275, 173 A. 248 (1934); United States Can Co. v. Freiberg, 30 Ohio App. 476, 165 N.E. 593, *appeal dismissed*, 120 Ohio St. 615, 169 N.E. 304

debts as they become due in the usual course of the debtor's business"[30] is typical.

A. *New Jersey Approach*

In New Jersey, the jurisdiction which has perhaps more cases in which the equity definition of insolvency is employed than any other, the corporation statute contains two definitions for technical or equity insolvency. One, like that in the old Model Act is used for most corporate law purposes.[31] The other definition is used specifically for corporate reorganization, appointment of receiver and corporate fraudulent conveyance purposes. Under this definition a corporation is insolvent either if its assets at fair value are not "sufficient in amount to pay its debts" or if the corporation is "unable by its available assets or the honest use of credit, to pay its debts as they become due."[32] The second alternative is a more focused equity insolvency test—the resources available to meet debts as they become due are assets at fair value of credit. Regardless of the definition used, there is exasperatingly little discussion in the cases of an approach or methodology to be employed in making the factual determination of insolvency. Occasionally opinions simply recite the definition and do little more than conclude that the entity was, or was not, solvent.[33]

One notable exception is *Hoagland v. United States Trust Co.*[34]

(1929); Illinois Ref. Co. v. Illinois Oil Co., 130 Okla. 27, 264 P. 904 (1928); Northern State Constr. Co. v. Robbins, 76 Wash. 2d 357 457 P.2d 187 (1969). *See generally* FLETCHER, *supra* note 27, at § 5324.

30. N.Y. BUS. CORP. LAW § 102(a)(8) (McKinney 1963).

31. N.J. STAT. ANN. § 14A:1-2(k) (West 1969). The Commissioners' Comment to this section states that the definition is based on § 2(n) of the old Model Act.

32. N.J. STAT. ANN. § 14A:14-1(f)(1)-(2) (West 1969). There is a separate definition of insolvency for general fraudulent conveyance purposes: "saleable value of assets is less than . . . existing debts as they become absolutely dissolute and matured." N.J. STAT. ANN. § 25:2-8 (West 1940). This definition is based on the Uniform Fraudulent Conveyance Act § 2, 7A U.L.A. 176 (1978).

33. *See, e.g., In re* Schulte Retail Stores Corp., 22 F. Supp. 612 (S.D.N.Y. 1937); Royal Academy of Beauty Culture & Royal Beauty Shop, Inc. v. Wallace, 226 Ind. 383, 78 N.E.2d 32 (1948); Stang v. Puget Sound Nat'l Bank of Tacoma, 188 Wash. 503, 63 P.2d 373 (1936).

34. 110 N.J. Eq. 489, 160 A. 662 (N.J. Ch. 1932), *aff'd per curiam*, 113 N.J. Eq. 30, 166 A. 197 (N.J. 1933). *See also* Bielaski v. Nat'l City Bank, 58 F.2d 657 (S.D.N.Y. 1932); Kenny v. Allerton Corp., 17 Del. Ch. 219, 151 A. 257 (1930); Ebling Brewing Co. v. Heirloom, Inc., 136 N.J. Eq. 441, 56 A.2d 749 (N.J. Ch. 1948); Glauberman v. Bergenline Trust Co., 108 N.J. Eq.

This case, like so many in this area of the law, is a depression era suit by a bankruptcy trustee to set aside preferential transfers made by a bankrupt corporation. A prominent construction company with assets significantly in excess of liabilities, was in a typically tight cash position. It was, however, able to meet all of its obligations until the filing of the petition in bankruptcy. The vice-chancellor in this case meticulously recited the financial chronology of the company during the relevant months. He concluded, based on the factual evidence of the company's relationships with its lenders and the value of its collateral,[35] that the company was solvent when the payments in question—repayment of certain loan obligations—were made. Although the court did not utilize a well articulated methodology in reaching its conclusion, it did examine the financial condition of the company in great detail. The trustee had based his argument that the company was insolvent at the time of the payments on the current asset test. This test provides that equity insolvency exists if current liabilities exceed current assets.[36] While the court commented on the valuations used by the accountants to demonstrate equity insolvency under this test, it did not base its conclusion that the company was solvent at the time of the transfers on its current position. Instead, it reached the conclusion that the company was solvent based on a factual assessment of the company's viability at the time of the transfers.

B. *Current Assets Approach*

In addition to the *ad hoc* approach as used in the *Hoagland* case, the current asset test has been employed to determine equity solvency.[37] The test has the principal advantage of ease of application and certainty. A corporation with current liabilities in excess of current assets may well be technically insolvent, or insolvent in

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531, 155 A. 766 (N.J. Ch. 1931); Auburn Button Works, Inc. v. Berryman Elec. Co., 107 N.J. Eq. 554, 154 A. 1 (N.J. Ch. 1931).

35. The court was applying the predecessor of N.J. STAT. ANN. § 14A:14-1(f)(2) (West 1969).

36. *See* B. B. HOWARD & M. UPTON, INTRODUCTION TO BUSINESS FINANCE, 131-39 (1953); Walter, *Determination of Technical Solvency*, 30 J. BUS. 30 (1957).

37. Bielaski v. Nat'l City Bank, 58 F.2d 657 (S.D.N.Y. 1932); Kraft v. Rochambeau Holding Co., 210 Md. 325, 123 A.2d 287 (1956). *See* Kummert, *The Financial Provisions of the New Washington Business Corporation Act*, 42 WASH. L. REV. 119, 131 (1966). *See also* Banks v. Christina Copper Mines, Inc., 34 Del. Ch. 44, 99 A.2d 504 (1953).

the equity sense, because it may be generally unable to meet its maturing obligations.

The main difficulty with this test lies in its use to the exclusion of other factors. The current asset test, like the balance sheet approach, is a rigid, static approach to solvency determination. It tells nothing of a corporation's ability to match its maturing liabilities against proceeds from borrowings or the renegotiated terms of liabilities. Further, possible increased revenues from increased demands for products are not considered relevant. All of these factors are characteristics of a dynamic, ongoing concern. Moreover, the test may be inherently deficient to the extent that it would include as a current asset, available to meet current expenses, the entire value of the inventory, generally at cost.[38] A more meaningful value to include would be the dollar value that could be raised through the sale of inventory during the relevant period.[39] However, to make judgments regarding the amount of inventory that could be sold during the relevant period and the pride of these sales is to inject subjective elements into the application of the

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38. Interestingly, new § 45 provides that the balance sheet solvency determination in subparagraph 45(b) may be "based upon (i) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances, or (ii) a fair valuation or other method that is reasonable in the circumstances." *Changes, supra* note 1, at 1872. No comparable statement is made with respect to the valuation of assets used in the equity solvency determination of subparagraph (a) of new § 45. It is implicit, of course, since the equity solvency determination under the Model Act depends in part on revenues and cash inflows from the sale of products. *See* Walter, *supra* note 36, at 30-32.

39. For example, assume that the current portion of a corporation's balance sheet reads as follows:

	Assets		Liabilities
$ 1,500	cash	$12,000	liabilities
10,000	inventory, 10,000 units at cost		
11,500		12,000	

The current asset test would indicate that the corporation was insolvent since current liabilities exceed current assets. If during the current period 5,000 units of inventory could reasonably be expected to be sold at a unit price of $2.25 each, the company would be solvent. [$1,500 cash + $11,250 inventory sale (5,000 units x $2.25) = $12,750 current assets against $12,000 current liabilities].

Valuation of the entire inventory of 10,000 units at the higher $2.25 fair market value would result in an even greater margin of safety, but would be as misleading as a cost valuation. It assumes that all 10,000 units would be sold during the relevant period.

test; the advantage of the test lies precisely in the absence of these elements.

III. Equity Solvency: Model Act Section 45(a) and Comment

A. *Comparison with Other Approaches*

Against this background the approach to equity insolvency contained in the Comments to new section 45 can only be viewed as extremely helpful. The Comment sets a clearer framework within which a factual analysis as performed in cases such as *Hoagland* can be undertaken; on the other hand, it avoids the rigid results of the application of a current asset test or its resulting current and working capital ratios.[40] Since many state corporation statutes, both those patterned on the Model Act and others, have generally the same definition of equity insolvency, the approach to the determination of equity insolvency articulated in the Comment provides a most useful methodology even if new section 45 is not adopted by the state legislatures. Although the approach taken in the Comment to new section 45 is not substantively different from that in the old Model Act,[41] it is far more expansive and helpful.

B. *Cash Flow Requirement—Possible Additional Director Liability*

As articulated in the Comment to new section 45:

> What is appropriate for an on-going business enterprise is a cash flow analysis based on a business forecast and budget for a sufficient period of time to permit a conclusion that known obligations of the corporation can reasonably be expected to be satisfied over the pe-

40. The current ratio is current assets divided by current liabilities. Working capital is current assets minus current liabilities. Working capital ratios can be obtained by dividing sales, fixed assets or capitalization by working capital. *See generally* B. Graham & C. McGolrick, The Interpretation of Financial Statements, 8-17 (rev. ed. 1964).

41. In discussing the insolvency limitations on the payment of dividends, the Comment to old § 45(a) states: "The term 'insolvent' is defined in section 2(n) to mean inability to pay debts as they become due. It is a cash flow test in the equity sense of insolvency, rather than a value test as used in the Bankruptcy Act." Model Bus. Corp. Act Ann. 2d § 45 at 891 (1971). The old Model Act thus rejected the notion of a current asset test. However, it gave no guidance as to how a cost flow analysis was to be prepared. *See*, de Capriles, *New York Business Corporation Law: Article 5—Corporate Finance*, 11 Buffalo L. Rev. 461, 468 (1962).

riod of time that they will mature rather than a simple measurement of current assets against current liabilities, or a determination that the present estimated "liquidation" value of the corporation's assets would produce sufficient funds to satisfy the corporation's existing liabilities.[42]

Additional guidance is provided regarding certain assumptions that the directors are entitled to make in preparing the cash flow analysis:

> In making this determination, the directors are required and entitled to make certain judgments as to the future course of the corporation's business, including the likelihood that, based on existing and contemplated demand for the corporation's products or services, it will be able to generate funds over a period of time from its . . . assets sufficient to satisfy its existing and reasonably anticipated obligations as they mature. The directors are entitled to expect that substantial indebtedness which matures in the near-term will be refinanced where, on the basis of the corporation's financial condition and future prospects, and the general availability of credit to businesses similarly situated, it is reasonable to assume that such refinancing may be accomplished. To the extent that the corporation may be subject to asserted or unasserted contingent liabilities, the directors are required and entitled to make judgments as to the likelihood, amount and time of any recovery against the corporation, after giving consideration to the extent to which the corporation is insured or otherwise protected by others against loss.[43]

By eliminating the affirmative sources for dividend or share repurchase distributions, new section 45 affords the board of directors with a maximum amount of flexibility. Arguably, it imposes no new duties on the board. Under the old Model Act, the directors were required to reasonably determine[44] the amount of dividends or distributions within the legally available sources. In such determinations the legitimate interests of creditors, the shareholders and the corporation's future needs ought to be assessed. In a sense new section 45, by eliminating stated capital and the sources of

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42. *Changes, supra* note 1, at 1882.
43. *Id.* at 1881-82.
44. *See* Model Bus. Corp. Act Ann. 2d § 45(a) Comment (1971).

dividends or distributions, merely increases the maximum allowable distributions, and requires the board of directors to make the same judgments only with a larger aggregate sum. However, if there were no legally available sources (as for example if a corporation had no earned surplus, but a large amount of stated capital), no judgments could be made under the old Model Act. Whereas under new section 45 the judgment can be made. Also, without the cushion of stated capital, the consequence of the judgments required by new section 45 may be more serious. Moreover, the revised statute itself reinforces the seriousness of these determinations.

Section 48, dealing in part with express director liability for the amounts of payments to shareholders not authorized by the statute, has been revised to state explicitly that a director voting for or assenting to[45] a distribution contrary to the provisions of the Model Act or the articles of incorporation shall be liable for the illegal portion of the distribution *"unless he complies with the standard provided in this Act for performance of the duties of directors."*[46]

The Comment to new section 48 indicates that a director avoids liability if he complies with the standard of care set forth in section 35.[47] One might conclude from this phrasing that the Comment is intended to circumscribe potential director liability by indicating means of avoiding liability. The approach of the revised statute itself is much more affirmative than that in the Comment. It provides that a director voting for or assenting to a distribution "shall, *unless* he complies with the standard . . ., be liable to the

45. Section 35, which has not been revised, contains a working definition of the term "assented."

> "A director . . . who is present at a meeting of its board of directors . . . shall be presumed to have assented to the action taken unless his dissent shall be entered in the minutes of the meeting or unless he shall file his written dissent to such action with the secretary of the meeting before the adjournment thereof or shall forward such dissent by registered mail to the secretary of the corporation immediately after the adjournment of the meeting. Such right to dissent shall not apply to a director who voted in favor of such action."

MODEL BUS. CORP. ACT ANN. 2d § 35, ¶ 3 (Supp. 1977).

46. *Changes, supra* note 1, at 1873 (emphasis in original).

47. *Id.* at 1886.

corporation."[48] The phrasing in the revised statute, although grammatically awkward, literally imposes a blanket liability and then creates an exception when the standard of care is met. This approach is much different from that contained in section 35, itself, which is more neutrally stated.[49] An inference could be drawn that

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48. *Id.* at 1873 (emphasis added). The revision in its entirety provides in pertinent part:

> In addition to any other liabilities, a director . . . who votes for or assents to any distribution . . . contrary to the provisions of this Act, or contrary to any restrictions contained in the articles of incorporation, shall, *unless he complies with the standard provided in this Act for the performance of the duties of directors,* be liable to the corporation, jointly and severally with all other directors so voting or assenting, for the amount of such dividend which is paid or the value of such . . . distribution in excess of the amount of such distribution which could have been made without a violation of the provisions of this Act or the restrictions in the articles of incorporation.

Id. (emphasis added).

The pertinent language in old § 48 reads:

> In addition to any other liabilities, a director shall be liable in the following circumstances unless he complies with the standard provided in this Act for the performance of the duties of directors:
>
> (a) A director who votes for or assents to the declaration of any dividend or other distribution of the assets of a corporation to its shareholders contrary to the provisions of this Act or contrary to any restrictions contained in the articles of incorporation, shall be liable to the corporation, jointly and severally with all other directors so voting or assenting, for the amount of such dividend which is paid or the value of such assets which are distributed in excess of the amount of such dividend or distribution which could have been paid or distributed without a violation of the provisions of this Act or the restrictions in the articles of incorporation.

MODEL BUS. CORP. ACT ANN. 2d § 48 (1971).

49. The standard of care as contained in § 35 requires that:

> A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:
>
> (a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,
>
> (b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence, or
>
> (c) a committee of the board upon which he does not serve, duly designated in accordance with the provision of the articles of incorporation or the by-laws, as to the matters within its designated authority, which committee the director reasonably believes to merit confidence, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.

new section 48 shifts the burden of proof to the directors to show that they met the requisite standard. This would be a departure from existing law in which the burden of proof in standard of care cases, as distinct from fiduciary duty cases, is on the plaintiff.[50]

For these reasons it is fortunate that the Comment to new section 45 provides the directors with a great deal of guidance as to how the determinations required by new section 45 are to be made. Moreover, the Comment not only incorporates the standard of care set forth in section 35 but also indicates that the judgments and definitions called for are specific activities regulated by the pervasive principles of section 35.[51] It explicitly restates the reliance on experts defense contained in section 35 by providing that in making the judgments and assumption necessary to reach a conclusion

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MODEL BUS. CORP. ACT ANN. 2d § 35 (Supp. 1977).

For recent discussion of the standard of care cases, see generally Arsht, *Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L., 651 (1979); Arsht & Hinsey, *Codified Standard—Same Harbor But Charted Channel: A Response*, 35 BUS. LAW. 947 (1980); Maxwell, *Accountability of Officers and Directors*, 4 DEL. J. CORP. L. 781 (1979); Veasey, *Directors' Standard of Care Under Section 35 of the Model Business Corporation Act*, 4 DEL. J. CORP. L. 665 (1979); Veasey & Manning, *Codified Standard-Safe Harbor or Uncharted Reef*, 35 BUS. LAW. 919 (1980).

50. *See* Kamin v. American Express Co., 86 Misc. 2d 809, 383 N.Y.S.2d 807, *aff'd*, 54 A.D.2d 654, 387 N.Y.S.2d 993 (1976). *See also* Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980); Auerbach v. Bennett, 64 A.D.2d 96, 408 N.Y.S.2d 83 (1978), *aff'd*, 47 N.Y.2d 619, 343 N.E.2d 994, 419 N.Y.S.2d 920 (1979). *But see* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), *rev'g*, Maldonado v. Flynn, 413 A.2d 1251 (Del Ch. 1980).

The version of old § 48 quoted in note 48, *supra* was contained in a 1974 revision to the Model Act. The 1974 amendment added the following language to the preamble: "a director shall be liable in the following circumstances unless he complies with the standard provided in this Act for the performance of the duties of directors. . . ." MODEL BUS. CORP. ACT ANN. § 48, at 364-66 (Supp. 1977); *Report of the Committee on Corporate Laws: Changes in the Model Business Corporation Act*, 30 BUS. LAW. 501 (1975); *Report of the Committee on Corporate Laws—Changes in the Model Business Corporation Act*, 29 BUS. LAW. 947-50 (1974).

The amendment in new § 48 eliminates subparagraphs (b) and (c) which dealt with the directors' liabilities for purchases of shares for unauthorized sources and improper liquidation distributions. It also combined the preamble with the substance of old subparagraph (a). The phrase "in the following circumstances" was consequently eliminated from the preamble since the reference was no longer necessary. The elimination of that phrase results in the juxtaposition of the notions that the director is liable unless he complies with the standard of care. It may therefore be unwarranted to infer that new § 48 intended any change in the burden of proof. Insofar as new and old §§ 48 deal with the same substantive areas, the ambit of director liability appears to be the same. Nevertheless, the phrasing of new § 48 is striking and highlights the liability.

51. *Changes, supra* note 1, at 1882.

regarding the corporation's solvency after a distribution, the directors "are entitled to rely on information, the opinions reports and statements prepared by others."[52] Since the determinations regarding certain variables included in a cash flow analysis require a degree of expertise in financial, sales and operational matters, the board of directors will most likely leave these assessments to corporate employees and affirm their conclusions regarding solvency, thereby limiting their personal liability under section 48.

C. *Varying Approaches to Cash Flow Analysis*

A cash flow analysis, the Comment indicates, is the appropriate means of determining equity solvency. For the large corporation, the use of the cash flow approach is a less troublesome matter. First, for a variety of reasons, it may be less significant. There may be less likelihood that such a corporation would contemplate payments to its shareholders of such magnitude as to be seriously hampered by the equity insolvency test. Second, such a corporation has readily available the expertise necessary to produce a cash flow analysis in which all of the reasonably anticipated variables as stated in the Comment are considered. As under the old Model Act, it is the small corporation for which the new Model Act will be most troublesome. The following are some general considerations regarding cash flow analyses and the Comment which may be of some assistance.

Cash flow projections routinely prepared for various financial and management purposes, including determining cash or financing requirements and managing money market investments, could be adopted for use in making the solvency determination required by new section 45. Two methods are commonly used to predict cash flows, and with some modification could be used for section 45 purposes. The language of the Comment to the effect that what is required is a "cash flow analysis based on a business forecast and budget for sufficient period"[53] is not sufficiently clear as to indicate a preference for one system over the other.

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52. *Id.*
53. *Id.*

1. Adjusted Net Income

a. Description

One approach to cash flow is referred to as the adjusted net income, or sources and uses of funds approach.[54] Under this method, cash flow is equated with net income plus depreciation and depletion. Said another way, cash flow equals the difference between sales or revenues and all expenses other than depreciation. This system has been fairly recently popularized by financial analysts as a means of assessing one corporation's financial condition in relation to others. Such comparisons are difficult in part because of the myriad variations in depreciation practices. Thus if depreciation is added back into net income there is a truer basis for comparison.[55]

This system of cash flow analysis has been criticized as being inherently deficient, because of its treatment of depreciation and depletion.[56] Also the conclusion from the analysis, that the funds generated by operations are available for use at management's discretion, may be misleading.[57] Nevertheless, it is widely used by those outside a corporation as a comparative tool. It is likewise suitable for internal use, perhaps more for long range forecasting and as a means of predicting future financing need than as a measure of equity solvency.[58] However, to the extent it shows the need for future financing, it focuses inquiry on some of the assumptions referred to in the Comment.[59] Moreover, this approach has the ad-

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54. D. Bellemore, H. Philips & J. Ritchie, Investment Analysis and Portfolio Selection, 417-18 (1979); J. Cohen, E. Zinbarg & A. Zeckel, Investment Analysis and Portfolio Management, 189-91 (rev. ed. 1973); B. Graham, D. Dodd & S. Cottle, Security Analysis, Principles and Technique, 172-78 (4th ed. 1962).

55. Graham, et al., *supra* note 54, at 172-78. Logically one might conclude that a more precise comparison would be to also add income taxes paid back into net income, since the taxes paid are also in part based on depreciation policy. Cohen, et al., *supra* note 54, at 190. However, since the taxes paid may be the consequence of some rather unique aspects of a corporation other than, or in addition to, depreciation practices, to add the taxes paid back into net income may result in the corporations being less comparable.

56. Graham, et al., *supra* note 54, at 172-79; Mauriello, Accounting for the Financial Analyst, 89-91 (rev. ed. 1971).

57. SEC Accounting Release No. 142 (March 15, 1973); 5 Fed. Sec. L. Rep. (CCH) ¶ 72,164. The cash flow data shows the liquid funds generated from operations. It gives the impression, if not properly qualified, that such funds are available for the discretionary use of management.

58. The Conference Board, Cash Management 13 (1973).

59. *See* text accompanying notes 89 to 92 *infra*.

vantage of having been adopted for use in assessing equity solvency.[60]

This form of analysis consists basically of three parts, like a source and use of funds statement. But it is prospective in nature rather than a statement for a period ended. First the time frame is determined; then the projected sources of cash, the uses of cash and the adjusted cash balance for that period are determined. The components in each of these parts can be broken out in some detail or left fairly general, particularly regarding the uses of cash.

The sources of cash typically are considered to be either net income before or after taxes or net sales, increases or decreases in receivables and current liabilities as against a prior period, and cash from external sources such as borrowings, and sales of securities or assets.[61] For purposes of the equity solvency determination the relative changes in the amounts of receivables and current liabilities over prior periods are not significant since the changes themselves generate no liquid assets which can be matched against maturing liabilities. If net income is used, depreciation must be added to net income.[62]

Differing methods are employed to ascertain the uses of the cash portion of the analysis. If in the sources of cash, the larger figure of net sales is used, the corresponding uses of cash will separately include the cost of goods and selling and administrative expenses, and all other expenses from operations other than depreciation.[63] Other uses of cash consist of taxes paid, increases and decreases in current assets other than cash (principally inventory) and accounts payable over a prior period, capital outlays, retirement of debt, reacquisition of stock and dividend distributions.[64] Again, for purposes of the equity solvency determination, increases and decreases in current assets over a prior period are not as significant as the aggregate amounts of the current liabilities.

If, alternatively, the sources of cash portion starts with net in-

60. Walter, *supra* note 36.

61. The cash flow statements contained in THE CONFERENCE BOARD, *supra* note 58, at 23 and COHEN, ET AL., *supra* note 54, at 396 were used for comparison purposes.

62. THE CONFERENCE BOARD, *supra* note 58, at 23.

63. COHEN, ET AL., *supra* note 54, at 396.

64. *Id.*

come plus depreciation, the expenses from operations cannot be separately reviewed since they are already taken into account in the determination of net income. As with the net sales approach, however, taxes paid,[65] capital outlays, and other expenses can be separately considered.

The last component, the adjusted cash balance, is the excess of cash inflows over outflows during the period. Arguably this adjusted cash balance ought to be the maximum available for corporate distribution. The assumptions necessary to assure that the enterprise can pay its obligations as they mature must have been resolved affirmatively for there to be a positive cash balance. If all of the cash balance were paid out, there would be at least an equivalence of outflow and inflow and presumably solvency. However, to pay all of the cash balance out would mean that no cash balance would be carried over into the next period. Therefore, the likelihood that insolvency might occur during that period is increased, since the corporation would start the period with no immediately available cash to meet imminent needs.[66] Hence it may be more appropriate to consider the projected cash need for the beginning of the next period as an outflow, or at lease a reserve in the period under review, thereby assuring sufficient cash in the beginning of the next period.[67]

b. Advantages

The advantage of the adjusted net income approach is that it clearly provides the framework within which the assumptions and variables referred to in the Comment may be considered. This is particularly so if the more expansive net sales format is used. In fact, there may be no need to use the net income form, since it is a second level of analysis of the same data. The information regarding both revenues and various expenses necessary to compile the net income projections is the same information separately considered in the net sales format. The Comment entitles the directors to make basic assumptions regarding the future course of business in-

65. Obviously if net income after taxes is used as the source of cash, taxes paid are not included as a use of cash.

66. *See* text accompanying note 76 *infra.*

67. Walter, *supra* note 36, at 39.

cluding the growth or decline in demand for the company's products or services.[68] Obviously the major source of cash is from sales. Use of the more expansive net sales approach makes possible an assessment of how much expenses rise and fall with changes in demand and how much of the expenses are relatively fixed. While the Comment explicitly authorizes the board to consider changes in demand, it does not explicitly refer to other changes in operating costs. Presumably the directors must consider these factors since the Comment requires an analysis based on a "business forecast and budget."[69]

c. Drawbacks

Use of this form of cash flow analysis presents several major difficulties. The first is its treatment of depreciation or depletion. The concern over depreciation is perhaps inherent in cash flow analyses generally and not a defect in a particular form of analysis. This difficulty stems from the cash flow's shorter term focus. True, depreciation is not a cash outlay, and thus is not a drain on liquid assets. If during a given period revenues were generated, and the only expense was depreciation, there would be no cash outflow; all revenues would appear to be available for distribution. Yet, if a long-range view is taken, depreciable assets will require replacement at some indefinite future time. There would be cash outflows of fairly sizeable amounts when replacement is required. Since one purpose of depreciation is to withhold cash from earnings in order to provide for replacement[70] of assets in an orderly fashion, and since depreciation is a real expense,[71] it may make sense to recognize it a such in the cash flow analysis. Yet to do so diminishes the amount available for shareholder distribution. Moreover, to do so may serve little useful purpose. If an amount were reserved for depreciation during the period under review and not spent on replacements, the value of assets at the beginning of the next period will include the unexpended portion of the depreciation service. Unless the unexpended fund is cumulatively carried over

68. *Changes, supra* note 1, at 1881.
69. *Id.* at 1882.
70. COHEN, ET AL., *supra* note 54, at 193.
71. BELLEMORE, ET AL., *supra* note 54, at 417; GRAHAM, ET AL., *supra* note 54, at 174-76.

from period to period as an outflow, only the current depreciation charge would be deducted each period; such current charges may be insufficient to be of use for replacement purposes.

Fortunately, the problem of whether or not to include depreciation in the analysis may not arise too frequently. When the board is determining whether or not to make a distribution, as by dividend payment, it exercises its discretion as to the amount of payment within an allowable maximum. As under the old Model Act, when a dividend could be paid from earned surplus, the directors were not required to pay out all of earned surplus. So under the new Model Act nothing requires the directors to make the maximum distributions allowable under the cash flow analysis. The problem will arise, and the issue of whether depreciation deductions are not prudent but are permitted will be critical in the context of whether the corporation is legally capable of making certain distribution, such as preferred stock dividends.[72] A corporation may be insolvent, as demonstrated by a cash flow analysis including depreciation as an outflow, if a preferred stock dividend were paid. It is hence legally incapable of paying the dividend. On the other hand, if depreciation is not included as an outflow, the dividend payment may not render the corporation insolvent.

Since the conventional use of cash flow analyses is not to include depreciation as an outflow[73] and since the Comment and the statute contain no guidance, the temptation may be not to include it. If a decision were made to include depreciation, the manner of computing the allowance is not difficult. Simply determining the depreciation on the basis of the past year's allowance for the period of time under review, a quarter or six months, ought to be a reasonable estimate. If a depreciation allowance is not taken, a careful analysis of the replacement cost of all assets to be replaced during the period under review must be undertaken, and such aggregate replacement cost must be included as a cash outflow.

This analysis might require a significant amount of effort and many specific judgments about what items need to be replaced and

72. *See generally* Buxbaum, *Preferred Stock Law and Draftsmanship*, 42 CAL. L. REV. 243 (1954).

73. *See* note 54 *supra* and accompanying text.

for which items replacement can be postponed to a later date. Variations among corporations regarding treatment of payments as expenses or capital expenditures, for accounting and internal corporate approved purposes, may require that a separate line in the cash outflow be used for this analysis, rather than the one focusing on capital outlays.

In lieu of this type of analysis, a fixed sum, representing the amount typically expended during a period of time equal to the period under review for replacement of assets, could be taken as a cash outflow. This sum, though based on prior experience, could be adjusted by adding to it the anticipated replacement cost of sizeable assets. If this were done, an amount equal to the periodic depreciation need not be included as an outflow. The careful analysis of replacement costs serves the function of depreciation within the cash flow analysis.[74] Hence to also include depreciation would duplicative. A replacement analysis may be more accurate, since it is based on the cost of replacement. A depreciation allowance would typically be based on a portion of the original cost, not replacement cost.[75] The depreciation allowance for that very reason would be far easier to derive, however.

A second difficulty with the adjusted net income cash flow approach is that it tells nothing about timing, or bunching, of income and expenses. In some respects the adjusted net income cash flow analysis is similar to the current asset approach. If, for example, the cash flow projection is made for a period of six months, the projections of cash inflows and outflows which take place throughout the period are cumulative to the end of the period. The net cash balance shown is that projected to exist at the end of the period. There is no way to match an obligation maturing early in the period with cash available at that time. This problem may be ameliorated by requiring at the opening of the period under review a cash balance sufficient to meet obligations reasonably projected to mature before sufficient cash is generated during the period.[76] Al-

74. Depreciation serves two basic functions. First it allocates the cost of assets over their useful life. Second and more importantly for cash flow purposes, it provides a fund for replacement. COHEN, ET AL., *supra* note 54, at 193.

75. *Id.*

76. Walters, *supra* note 36, at 39.

ternatively, a series of cash flow analyses—each for a short period, such as two weeks—would minimize the cumulative effect of each analysis.

If the net cash balance projected at the end of the period under review is considered the maximum allowable distribution, but the distribution is to be made during that period, the problem of timing becomes more acute. The effect of the distribution on the corporation's ability to meet imminently maturing obligations must be considered. A better approach may be to include the amount of the potential distribution as a cash outflow as of the time of projected time of payment.[77] If when including this payment *pro forma* as an outflow, there is still a positive net cash balance, payment of the projected distribution probably would not put the corporation into insolvency. But more importantly, by including the distribution *pro forma,* a more accurate assessment of the effect of the distribution on the corporation's liquidity can be made.

Although this mismatching of available liquid assets with the maturing obligations can occur at any time, its consequence is not expressly provided for in revised section 45, or in most other statutes. Does such temporary inability to pay a maturing obligation constitute insolvency? It is generally believed that the inability to pay a single debt, or the temporary inability to pay all debts does not constitute insolvency.[78] Instead, equity insolvency is said to be the general inability to meet obligations as they mature because of the overall financial condition of the enterprise.[79] Since the Comment to new section 45 focuses on the going concern aspects of a corporation when making distributions, such temporary embarrassments presumably would not constitute equity insolvency under new section 45.

2. Receipts and Disbursements Approach

The other type of cash flow analysis is commonly referred to as the receipts and disbursements method. Although it may be less useful for purposes of assessing the equity solvency of an enter-

77. *See* text accompanying notes 89-91 *infra.*

78. Hersch v. Levinson Bros., Inc., 117 N.J. Eq. 131, 174 A. 736 (Sup. Ct. 1934); Hoover Steel Ball Co. v. Schafer Ball Bearings Co., 89 N.J. Eq. 433, 105 A. 500 (Ch. 1918).

79. 117 N.J. Eq. 131, 174 A. 736 (Sup. Ct. 1934).

prise, it has a feature which overcomes one of the drawbacks of the adjusted net income approach.

Similarly to the adjusted net income approach, the receipts and disbursements method consists of a statement of projected cash inflows, receipts, and cash outflows, disbursements, and a cash balance. When the statement shows receipts in excess of disbursement, the resulting cash balance would be available for distribution to the shareholders. To this extent there is little difference between the receipts and disbursements and the adjusted net income method.

In this form of analysis, the receipts generally considered as cash inflows are those arising from operations or those otherwise internally generated.[80] One of the main uses of this type of cash flow analysis is to determine the projected needs for outside financing. Hence, it stops at least one step short of the judgments necessary to establish equity solvency under this statute. Although the statement may show the need for a certain amount of external cash, it does not directly consider where the cash might come from, borrowing, renegotiated loans, sales of securities or assets, etc. Therefore, it may be difficult to satisfy the assumptions set forth in the Comment to new section 45 regarding financings from this form of analysis.[81]

Also, this approach considers the items of receipts and disbursements with a fairly high degree of specificity. Consequently, the user can more readily see fluctuations in items of inflow and outflow from one period to the next. Because of this specificity, this method generally can be used only for relatively short blocks of time, perhaps not more than a quarter.[82] Accordingly, it may be more useful for budget or highly controlled money management purposes than for a determination of equity solvency. The same specificity which is its principal drawback makes it possible to readily track or match projected income with expenses. It thus minimizes the bunching or gap problem that may exist under the net income approach.[83]

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80. THE CONFERENCE BOARD, *supra* note 58, at 7-12.
81. *But see* text accompanying notes 89-91 *infra*.
82. THE CONFERENCE BOARD, *supra* note 58, at 6.
83. *Id.* at 13.

For equity solvency purposes, its high level of specificity and relatively short, discrete time frames, present other serious problems. It is very narrow or focused. Since its emphasis is on receipts from operations or other internal sources, it tends to give an incomplete assessment of the cash which might be avalable from external sources. This failing perhaps could be rectified simply by modifying the format. However, since it employs short time frames, it may be difficult to accurately consider externally raised capital. Use of this method requires that conclusions be made about the financial position during the short period, which may be inaccurate in a longer period. If quarter periods are used, for example, the fact that a loan may be arranged five months hence is of no significance during the current quarter and the equity solvency during this discrete period may be questionable. Whereas, if the longer view were taken the assessment of the corporation's position during that longer period might be different.

In addition, the problem of the treatment of depreciation as an expense may be more serious under this method than under the adjusted net income approach. As in the net income approach depreciation is not generally treated as an expense. However, under the net income approach, it could be added back in. While this is also possible with this method, it may be more difficult to accurately determine the appropriate depreciation expense since the time frames are shorter. If a period of one year were considered in four quarters, it would be misleading not to consider depreciation in the first three quarters and to include all of it in the last quarter. On the other hand, if the attempt were made to determine the annual depreciation and then to include it in four equal quarterly amounts, attention is focused on the longer period—the year. If this were done, one may question why the receipts and disbursements method is attempted and modified to take into account the appropriate share of longer term expenses. Perhaps direct use of the adjusted net income method would be more efficient.

The Comments to revised section 45 do not specify the type of cash flow analysis which ought to be performed. However, the assumptions which the board is allowed to make and the variables which it is charged with considering indicate that the adjusted net income approach may be more appropriate.

D. *Director Liability for Failure to Use Cash Flow Analysis*

Revised section 45 provides the board with maximum flexibility regarding the amount of distributions to shareholders. The Comment to the section, however, balances this discretion with the articulation of an analytical framework within which the determination of whether a proposed distribution meets the equity solvency test must be made. The Comment does not merely authorize the use of a cash flow analysis, and then in general hortatory language allow the directors to make reasonable judgments; rather, the Comment requires that the directors make some fairly specific determinations. For example, in determining whether a distribution is allowable under the equity solvency test, the directors "are *required* and entitled to make certain judgments as to the future course of the corporation's business."[84] When discussing the consequence of contingent liabilities, the Comment states that the directors "are *required* and entitled to make judgments"[85] as to the likelihood of recovery. These fairly explicit directives are carried over into the language of this statute, in particular new section 48. The revisions to section 48 make explicit the director's liability for a distribution unless the director has "complied with the standard provided for in this Act for the performance of the duties of directors."[86] While there is nothing in the statute requiring use of a cash flow analysis or consideration of the variables referred to in the Comment, it may be difficult for a board of directors to meet the standard of care if it has made a judgment to distribute money to shareholders on some grounds other than cash flow analysis. Although the assumptions and variables found in the Comment are relatively self-explanatory, there are several noteworthy points.

IV. Ambiguities in the Statute and Comment

A. *Differing Articulation of the Test*

1. Proper Sources of Cash

The equity solvency test is articulated somewhat differently in the Comment than in new section 45(a). The Comment states that

84. *Changes, supra* note 1, at 1881 (emphasis added).
85. *Id.* at 1882 (emphasis added).
86. *Id.* at 1873. *See* text accompanying notes 48-50 *supra.*

a corporation is insolvent if it is unable "to pay its debts as they become due in the ordinary course of its business operations."[87] The test in the statute is somewhat more broadly stated as the corporation's ability "to pay its debts as they become due in the usual course of its business."[88]

The Comment version could be construed to focus on internally generated cash or cash from operations, and not to include external financing. The "usual course of its business" language in the text of new section 45(a) might be more broad, and might include cash generated by a business from sources other than its operations. Cash flow analysis and in particular the adjusted net income method would include proceeds from external financing.[89] It is not altogether clear from the Comment whether the directors are entitled to consider cash inflows from external financing in making the judgment about equity solvency. The Comment does not explicitly authorize inclusion of externally generated funds. In fact portions of the Comment appear to reinforce its notion of equity solvency as the inability to pay debts from operations.

While the Comment explicitly authorizes the Board to consider as sources of funds those generated from "its operations or from any contemplated orderly disposition of its assets"[90] no mention is made of anticipated proceeds from loans or securities offerings. This omission is all the more curious since the Comment explicitly permits the directors to consider that existing indebtedness will be refinanced (and thus not paid in the shorter term) in the event business and general credit conditions make such an assumption reasonable.[91] If the directors can consider the effects of refinancing, presumably they ought to consider proceeds from potential debt or equity financing or loan arrangements. The Comment, however, is silent on this point.[92]

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87. *Changes, supra* note 1, at 1881.

88. *Id.* at 1872.

89. *See, e.g.,* COHEN, ET AL., *supra* note 54, at 396; THE CONFERENCE BOARD, *supra* note 58, at 15-24.

90. *Changes, supra* note 1, at 1881.

91. *Id.* at 1881-82.

92. Of course, if external financings are not included, the receipts and disbursements form of cash flow analysis is more useful. *See* text accompanying notes 80-81 *supra.*

2. Liabilities

As in its treatment of sources of financing, the Comment is somewhat unclear in its treatment of liabilities. At one point the Comment states that the directors should employ a cash flow analysis sufficient to demonstrate that "known obligations"[93] can be satisfied. Yet, the preceding paragraph discusses "contingent liabilities and reasonably anticipated liabilities."[94] Despite this apparently inconsistent treatment of contingent or anticipated liabilities, it would, of course, be prudent for the directors to consider as liabilities to be met by revenue sources all known, actual or contingent and reasonably anticipated liabilities.

B. *Period of Solvency*

1. Period Begins "After Giving Effect to" Distribution

Perhaps the most uncertain aspect of both the new statute and the Comment is the duration of the time period during which solvency must be maintained. The first portion of new section 45(a) provides that distributions may be made unless "if after giving effect thereto"[95] either the equity or balance sheet test is not met. Fortunately, in a separate paragraph the statute explains the vague phrase "after giving effect thereto" and sets forth the time at which effect is given to the distribution, and hence the time at which the balance sheet and equity tests are applied.

This statute contains two separate measurement dates to be used, depending on the type of contemplated distribution. Whenever the corporation reacquires shares by purchase, redemption or otherwise, as part of the distribution, effect is given and the solvency test is applied at the earlier of the date on which cash or property is transferred or debt incurred or the date on which the shareholder ceases to be a shareholder with respect to the reacquired shares. In all other cases, and thus principally as to divided

93. *Changes*, *supra* note 1, at 1882. The admitted intention of the sentence in which "known obligations" appears is to draw a distinction between the use of a cash flow analysis, which measures the ability to meet maturing obligations, and the current asset approach. However, the sentence does not purport to define what constitutes an adequate cash flow analysis.

94. *Id.* at 1881-82.

95. *Id.* at 1872.

distributions, effect is given on the date of authorization if payment is made within 120 days of authorization, or on the date of payment if that date is more than 120 days from the authorization date.

This time sequence has eliminated a significant source of confusion which existed under the old Model Act. Section 6 of the old Model Act prohibited the "purchase of or payment for . . .",[96] its shares when it would render the corporation insolvent or when the corporation was insolvent. It then provided for the purchase of the shares from earned or capital surplus. If the shares were purchased but payments were made in installments, are the solvency and source of funds tests applied on the date of the purchase agreement or on each payment date? The case law is in conflict on this point.[97] The Comment to new section 45 recognizes this conflict and states that the equity and balance sheet solvency tests are to be applied at the date the debt is issued or incurred, and not at the date the debt is paid.[98] Although this statement avoids the case law confusion by establishing a clear rule, the rule is slightly inconsistent with the statute itself. The statute provides that the proper date for applying the tests is not the date on which the debt is issued or incurred, but rather the earlier date on which the debt is incurred or the date on which the shareholder ceases to be a shareholder with respect to the shares. This latter date may be ascertainable from the repurchase agreement or the articles of incorporation in the case of redemption. However, since the two dates would normally be the same or at least the date on which the debt is incurred would be prior to the date on which the interest as shareholder ceases,[99] any inconsistency is of little consequence.

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96. MODEL BUS. CORP. ACT. ANN. 2d § 6, at 253 (1971).

97. *Compare* Williams v. Nevelow, 513 S.W.2d 535 (Tex. 1974) *and* Robinson v. Wangemann, 75 F.2d 756 (5th Cir. 1935), which lead to the conclusion that the date of purchase, or delivery of the promissory notes is the operative date, and not the date of payment of the notes, *with* Wolff v. Heidretter Lumber Co., 112 N.J. Eq. 34, 163 A. 140 (1932), which supports the conclusion that the payment date is the operative date. *See generally* Herwitz, *Installment Purchase of Stock: Surplus Limitation,* 79 HARV. L. REV. 303, 322 (1965); Kessler, *Share Repurchases Under Modern Corporation Statutes,* 28 FORDHAM L. REV. 637, 645 (1959-1960).

98. *Changes, supra* note 1, at 1886.

99. U.C.C. § 8-301(1) provides, in part, that on transfer of a security, the transferee acquires the rights in the security which the transferor had. Presumably the transferor share-

While the statute and Comment have cleared the confusion regarding installment payments for shares, they may have, in a minor way, created the same confusion with respect to dividend payments. Old section 45 provided separately for the payment of cash, property and stock dividends. The statute was silent with respect to payment of a dividend by issuance of a debt instrument; it neither prohibits nor expressly authorized such a payment. Such dividends, while not common, are thought to be authorized unless prohibited by statute.[100] In contrast, the definition of a distribution in new section 2(i) of the Model Act appears to authorize such a dividend distribution. A distribution is a transfer by a corporation of money, property "or incurrence of indebtedness . . . to . . . its shareholders in respect of any of its shares, whether by dividend, or by purchase."[101] If a dividend distribution were paid by issuance of a debt instrument, when is the equity solvency test to be applied—the date of authorization, if payment through issuance of the instrument takes place within 120 days, or the date of cash payment of the instrument if that is more than 120 days from the date of authorization?

By analogy, the date on which the debt instrument is issued ought to prevail. When discussing acquisition of shares, the Comment states that the date the debt is incurred, not the date when it is actually paid, is the operative date for application of the solvency tests.[102] There appears to be no reason why the same approach ought not be used for a distribution in which the shares are not reacquired. Use of debt distributions may be advantageous in the context of the equity solvency test. They would have no immediate effect in the cash flow. Yet, the shareholders could resell the instrument at a discount or even use it as collateral, thereby receiving cash in hand, without a corresponding immediate cash outflow from the corporation. Of course liabilities would increase for purposes of the balance sheet test.

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holder ceases to have an interest in the shares, unless otherwise agreed, coincident with the acquisition of the rights by the transferee on transfer.

100. BALLANTINE, *supra* note 24, at § 240; FLETCHER, *supra* note 27, at § 5318.

101. *Changes, supra* note 1, at 1869.

102. *Id.* at 1886.

2. Duration of Period of Solvency

Within this time of application of the equity solvency test issue lies what is perhaps the most serious problem with the statute and Comment—the duration of the period of solvency. The Comment contains no guidance as to the length of time that a corporation must remain solvent after a distribution in order to satisfy the test. The only statement in the Comment regarding this point is that the focus of the directors' decision whether or not to make a distribution normally ought to be on the shorter term.[103] It would probably be unreasonable for the board of directors to authorize a distribution on the ground that a cash flow analysis for a fairly short period showed solvency while realizing that obligations maturing beyond that horizon might render the corporation insolvent at a later time. Hence application of the test will probably preclude a distribution which the board determines may render the corporation insolvent at any future time.

The difficult, and totally unanswered, question is what is the reasonable time period which the board ought to employ in making the equity insolvency assessment? Expressed another way, what would be the liability of a board of directors which authorizes a distribution on the basis of, for example, a six month cash flow analysis, if the corporation becomes insolvent in the eighth month? The obvious temptation is to consider, in hindsight, that the reasonable time frame is one which includes the date of insolvency.

Because of the widely differing circumstances confronting individual corporations, it would not have been practicable in the Comment to specify time frames. It is unfortunate, however, that no guidelines are provided as to how a reasonable time period could be constructed. For example, a discussion of the utility of operating cycles[104] as a basis for constructing an appropriate time frame might have been helpful.

V. Conclusion

In conclusion, by eliminating earned and capital surplus, the

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103. *Id.* at 1882.

104. *See* Bardahl Mfg. Corp. v. Commissioner, 24 T.C.M. 1030 (1965); D. Herwitz, Business Planning, 357-60 (Supp. 1981).

new statute may be perceived as providing directors with some additional flexibility regarding distributions to shareholders. As a practical matter however, the statute does not dramatically enlarge the ambit of their discretion. Directors have always had the flexibility to make distributions from both earned or capital surplus.[105] The distributions are still tempered, as they were under the old statute, by the notion of equity solvency. On the other hand, the Comment provides the board of directors with substantial guidance of the proper methodology to use in making the equity solvency determination. It is a highly significant improvement over the Comment to the old statute. Unfortunately, there is more guidance regarding relatively clear matters, and no guidance regarding the more critical issues.

105. MANNING, *supra* note 8, at 74. Accounting convention does not favor payment of a distribution from capital surplus if earned surplus exists. *See* DAVIDSON & WEIL, HANDBOOK OF MODERN ACCOUNTING 29-11 (2d ed. 1977).