A CRITICAL EXAMINATION OF STATE REGULATION OF ACCOUNTING PRINCIPLES

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Stanley Siegel analyzes the manner in which state law addresses issues of accounting principles. He uses corporate asset distributions to illustrate how state laws do not properly define accounting concepts. The resulting ambiguity in determining appropriate accounting principles makes it difficult for the corporate planner to ascertain when a distribution is proper. Conceding that Generally Accepted Accounting Principles are constantly changing, the author points out that they represent a narrower class of variability than current state law. The article concludes by recommending that state law incorporate GAAP on a selective basis.

1. Introduction

Contemporary writers in the area of corporate finance, particularly those concerned with legal constraints on corporate financial activities, appear to have reached a remarkable consensus that the traditional requirements of corporate capital structure — including minimum capital, par-value stock, and the separation of legal capital from capital surplus and retained earnings — are unnecessary [1]. Furthermore, they have argued for eliminating in large part the usual statutory limitations on corporate distributions, whether in the form of dividends or redemptions of stock, retaining only a test of solvency following distribution [2]. These arguments have borne fruit in the form of radically changed corporation laws, beginning with California [3], and continuing thereafter with revisions to the Model Business Corporation Act [4]. Although this changed view of legal capital has not yet found wide legislative acceptance, we may expect that it will in due course. One might conclude, therefore, that state law is finally about to withdraw — at least in part — from an area in which it has shown stunning incompetence over the past several decades: the choice and application of accounting principles. This conclusion would be erroneous.

State legal regulation is intimately concerned with the financial status and performance of enterprises. Even if the revised structure of the Model Business...
Corporation Act finds immediate wide acceptance – a somewhat unlikely prospect – the problems of defining financial status and performance will still remain. State law will still look – or refrain from looking or refuse to look – to accounting principles to determine when corporations may make distributions to their shareholders. As the law of limited partnerships becomes more crystallized in this era of expanding tax shelters, similar problems will arise with respect to partnership distributions [5]. Similar issues of accounting inhere in problems of trust law, estate valuation, and utility regulation. There is, in short, an irreducible minimum of financial information that must be referred to in state substantive law. These legal references may, as in the past, remain obscure, leaving to the courts the determination of what accounting principles are to be applied in interpreting the substantive command of the statutes. Alternatively, a body of principles may be adopted in the legislation itself, with appropriate limitations or variations to suit the particular needs of the statutory scheme.

This article examines the manner in which state laws address issues of accounting principles. These issues have been addressed, if at all, indirectly. State laws have used accounting terminology and concepts without any clear sense of their meaning, and in some instances with meanings clearly inconsistent with those understood by the accounting profession and by the readers of financial statements. With few exceptions, the states have evidenced ignorance of – and in some instances hostility towards – the concept of Generally Accepted Accounting Principles (GAAP) [6]. As a result, state laws have created confusion for attorneys and accountants alike, and have posed impediments to development and implementation of GAAP. A few states have adopted GAAP, in some degree, as a set of financial reporting standards within their corporation laws [7]. The principles that have been adopted in other state statutes, however, often have been ill-suited to the implementation of the underlying policy of the legislation.

The next two sections of this article illustrate the problems of incorporating accounting principles into state laws. The final section suggests several legislative approaches to the problem of accounting standards in state law.

2. Direct and indirect regulation of accounting principles under state law

2.1. The need for reference to accounting principles in state law

State laws governing a variety of financial transactions refer to accounting concepts for their substantive character. These include most notably state law limitations on distributions of assets by corporations and limited partnerships. Other state enactments – covering subjects ranging from public utility regulation to trust law and state taxation – also embody important elements of
accounting principles. To illustrate the problems, the discussion here focuses on problems raised by the corporation and partnership laws.

Corporate asset distributions, in the form of dividends, redemptions, or stock repurchases, are universally limited by state corporation laws [8]. Most jurisdictions retain the "earned surplus" standard. The language in the Model Business Corporation Act (prior to the 1980 revisions) is quite typical of the "earned surplus" requirement:

Dividends may be declared and paid in cash or property only out of the unreserved and unrestricted earned surplus of the corporation, except as otherwise provided in this section...[9].

Variations on this theme can be found in the corporation laws of many important jurisdictions, including New York [10], Delaware [11], and New Jersey [12]. Notably absent from these statutory formulations is any reference to GAAP. Indeed, with a few exceptions, the statutes give no guidance whatever on the choice or application of accounting principles. One might expect that the courts would look to GAAP or some legally-defined, but similar, collection of concepts. Litigation on the meaning of dividend statutes is uncommon, however, and a few very prominent decisions have adopted distinctly different principles, not always with desirable results. In the celebrated case of Randall v. Bailey [13], New York's highest court held that assets written up in value by appraisal could support the declaration and payment of a dividend. The subsequent bankruptcy of the payor corporation did very little to encourage widespread use of this dividend-enhancement technique, and a flurry of decisions and statutory amendments resulted in at least one accounting principle – prohibition of appraisal write-ups – becoming a part of the laws of several states [14]. At least one state [15] and the revised Model Act [16] have taken the opposite tack, explicitly authorizing appraisal valuation as a basis for unrestricted dividend distribution.

The machinations of corporations wishing to distribute dividends, but not satisfying the statutory standards, have long been the subject of critical comment. The most vocal and effective of critics of state regulation of dividends and corporate capital structure, Bayless Manning, wrote a text on the subject [17], advocating that state regulation should be largely eliminated. In California, the Manning approach was adopted almost intact [18]. In the revised Model Act, it was adopted fully [19]. Do these changes render it unnecessary for the states to concern themselves any longer with accounting principles?

Even a cursory examination of the California act demonstrates the remaining need for accounting principles in state corporate law. The two-fold dividend test of that act incorporates accounting principles at several levels. In the first instance, dividends and other distributions may validly be made in the
amount of the corporation's "retained earnings," a concept intentionally drawn from GAAP [20]. The second prong of the California test, that assets be at least equal to one and one-quarter times liabilities [21], similarly requires reference to accounting principles. California, along with a few other states, clearly calls for application of GAAP in these determinations [22].

The revised Model Act follows a different and perhaps more controversial course: the standard for permissible distributions is entirely based on the balance sheet and on a test of solvency. If the corporation is solvent immediately after the distribution, and if at that time assets exceed liabilities, the distribution is permissible [23]. Despite the apparent simplicity of this standard, an issue of accounting principles remains: on what basis will assets and liabilities be reflected for purposes of determining whether the standard has been met? Unlike California, the revised Model Act gives an ambiguous answer. The drafters, for reasons that will be discussed below [24], chose not to adopt GAAP. While the Model Act does not reject GAAP, it gives little comfort to those who rely upon GAAP to determine the appropriateness of a corporate distribution.

A somewhat similar set of ambiguities faces the lawyer advising a limited partnership with respect to distributions. For sixty years, the Uniform Limited Partnership Act left the question of legality of distributions to partners to the following cryptic phrase:

A limited partner shall have the right to receive a share of the profits or other compensation by way of income, and to the return of his contribution as provided in Sections 15 and 16 [25].

In the 1976 revision, the Uniform Limited Partnership Act (ULPA) adopted even more ambiguous distribution standards:

A partner may not receive a distribution from a limited partnership to the extent that, after giving effect to the distribution, all liabilities of the limited partnership, other than liabilities to partners on account of their partnership interests, exceed the fair value of the partnership assets [26].

The standards for "fair value," if any, are not stated, nor is any justification offered for adopting a different standard for distributions in limited partnerships than in corporations. Moreover, California, unique in this as in many other areas, adopted its own formulation of the Revised ULPA:

A partner is obligated to return a distribution from a limited partnership to the extent that, immediately after giving effect to the distribution ... all liabilities of the limited partnership, other than liabilities to partners on account of their interest in the limited partnership and liabilities as to which recourse of creditors is limited to specified property of the limited partnership, exceed the fair value of the partnership assets, provided that the fair value of any property that is subject to a liability as to which recourse of creditors is so limited shall be included in the partnership assets only to the extent that the fair value of the property exceeds this liability [27].
Here again, the meaning of the valuation standard "fair value" is open to question [28].

2.2. Variability in terminology and standards under state law

Generally, state statutes make no explicit references to accounting principles. The terminology used, though capable of interpretation under GAAP, may be construed in several alternative ways. The most common formulations in dividend statutes use the terms "assets," "liabilities," "surplus," and "earned surplus" in definitions that defy ready interpretation [29]. Thus, section 2 of the Model Act reads as follows:

(i) "Net assets" means the amount by which the total assets of a corporation exceed the total debts of the corporation. ...  
(k) "Surplus" means the excess of the net assets of a corporation over its stated capital. ...  
(l) "Earned surplus" means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation ... after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus [30].

The meaning of "earned surplus" ultimately turns on the meaning of "total assets," as to which the original Model Act gave no guidance. Are total assets to be stated under GAAP or valued periodically by appraisers, or is some other method or combination of methods permissible? The absence of significant litigation on this point is both understandable and disturbing. Given the potential liability of directors and shareholders for illegal distributions [31], and the ability of careful corporate planners to create the necessary "surplus" if it is not already present in adequate amount [32], one would expect that the issue of illegality would arise only rarely, and then only when the lawyering was faulty. However, the absence of any substantial decisional gloss on these ambiguous terms leaves the corporate planner in a quandary. As one leading commentator has suggested, there must be instances - though it would be difficult to evaluate empirically their importance - in which attorneys have counseled against effecting an economically desirable distribution because it could not meet the statutory standard [33]. Because the standards are unclear, there will inevitably be situations in which the advice to distribute or not to distribute will be wrong.

In the area of partnership law, the Revised Uniform Limited Partnership Act adopts a standard of "fair value," with no further explanation [34]. Since the meaning of "fair value" has yet to be construed in the context of this new act, and since the meaning of this term has been the subject of widely varying interpretations in other contexts [35], the partnership planner must similarly contend with ambiguity.

As noted earlier, several statutes have clarified the applicable standards,
whether by narrowing the permissible accounting techniques or by adopting, to a greater or lesser degree, generally accepted accounting principles [36]. The revised financial provisions of the Model Business Corporation Act follow a different course. The revised language contains the most permissive standard with respect to corporate distributions, prohibiting distributions only to the extent that after giving effect thereto: (1) the corporation would be unable to pay its debts as they become due in the ordinary course of business (an insolvency test); or (2) the corporation's total assets would be less than the sum of its total liabilities and – unless otherwise provided in its articles – the preferential liquidation rights of any outstanding preferred stock (a balance sheet test) [37]. Accounting principles are not determinative of a firm's actual ability to pay and are, therefore, essentially irrelevant under an insolvency test. However, satisfaction of the balance sheet test requires application of accounting principles. On this point, the Model Act abdicates all responsibility. The applicable standards are:

Determinations under subparagraph (b) [the balance sheet test] may be based upon (i) financial statements prepared on the basis of accounting principles and practices that are reasonable in the circumstances, or (ii) a fair valuation or other method that is reasonable in the circumstances [38].

The Committee on Corporate Laws stated:

Incorporating technical accounting terminology and specific accounting concepts into new section 45 was rejected, principally because such terminology and concepts are constantly under review and subject to revision by the Financial Accounting Standards Board, the American Institute of Certified Public Accountants, the Securities and Exchange Commission and others.

While the directors will normally be entitled to use generally accepted accounting principles and to give presumptive weight to the advice of professional accountants with respect thereto, it is important to recognize that the new Section requires the use of accounting practices and principles that are reasonable in the circumstances, and does not constitute a statutory enactment of generally accepted accounting principles. In the view of the Committee, the widespread controversy concerning various accounting principles, and their constant reevaluation, requires a statutory standard of reasonableness, as a matter of law, recognizing that there may be equally acceptable alternative solutions to specific issues as well as areas requiring judgment in interpreting such principles [39].

The revised Model Act solution to the problems of interpretation is, therefore, to remove essentially all restrictions on distribution. However, not all state legislatures may agree with this solution. Some jurisdictions, like California [40], may retain some substantive restrictions even after possible liberalization. More importantly, even under the most permissive statutory structure some standards must remain [41]. The problems of measurement posed by permissible accounting principles are inescapable, and the Model Act approach is not an effective solution to the problem.
3. The implications of variability in state accounting standards

3.1. Substantive non-uniformity among state laws

Perhaps the strongest argument that might be made for refusal to refer to GAAP within the state statutes is that the statutory policy may call for different substantive standards of accounting. For example, it would be clearly inappropriate to insist upon full application of GAAP in the calculation of taxable income under federal and state income tax regimes, for the reason that a myriad of tax policies are at variance with the purposes of GAAP. The tax policies have among their objectives raising of revenue, creation of incentives for certain conduct, and establishment of disincentives for other conduct. Generally Accepted Accounting Principles have as their principal objective the generation of informative financial statements for use by investors, creditors, and others. As an illustration, the Accelerated Cost Recovery System (ACRS) introduced by the Economic Recovery Tax Act of 1981 [42] was conceived as advancing the objective of increasing capital investment; its variance from GAAP accounting for depreciation was conscious and intended [43].

To the extent that variation from GAAP is a reflection of articulated state policies, the debate must focus on the desirability of the policies and not on the incidental fact that GAAP will not be followed. There is, however, very little evidence that the ambiguity and variability of corporate dividend standards — or of partnership distribution limitations — was borne of such conscious legislative policy concerns. A class of notable exceptions, discussed earlier herein, encompasses the state laws that have spoken definitively on the question of appraisal revaluation of assets [44]. With this exception, however, it does not appear unfair to characterize the present collection of state laws bearing on dividends as being unintentionally obscure. The language of most of these laws can be traced to the first few decades of this century, a time when even accountants had not clearly articulated accepted principles of reporting. It is not surprising, therefore, that many of the statutes (most of which to this day continue to use the long-abandoned terminology of “earned surplus” [45]) neither articulate an internal set of accounting principles nor refer to GAAP.

Less understandable is the decision of the Model Act draftsmen to continue that ambiguity through the last decades of this century. In the approximately fifty years since the early dividend statutes were drafted, the principles of accounting have been widely debated and at least partly crystallized. It is true, as the Committee on Corporate Laws has said, that “such terminology and concepts are constantly under review and subject to revision. . . .” [46]. However, the Committee’s choice is one of conscious preservation of ambiguity, as the Act sets forth no standards other than reasonableness. If widely adopted, the revised Model Act formulation is likely to result in the application of varying standards to corporate distributions not only from state to state, but from court to court and attorney to attorney within any given state.
The less conscious choice of the drafters of the revised Uniform Limited Partnership Act is likely to lead to similar ambiguity, since the term "fair value" as applied to assets has a very wide range of possible meanings.

3.2. Planning and disclosure problems caused by ambiguous standards

Ambiguity and variability in the state standards produce a series of unfortunate results. Perhaps the most important of these is that the advisor, whether attorney or accountant, often cannot be sure whether a desired transaction meets the statutory standard. Undoubtedly, most corporate and partnership distributions are well within the statutory limitations, however those limitations may be construed. But one important class of transactions, involving redemption of a major shareholder or repurchase of the interest of a significant partner, often cannot be so summarily dealt with. For example, commentators for years have wrestled with the standard applicable to installment repurchase of corporate shares, in part as an attempt to deal with the surplus limitations applicable to substantial share repurchases [47]. The timing questions of installment repurchases may finally have been resolved by the Model Act and California statutory language [48], but the larger issues of asset valuation and applicable accounting principles remain.

It can no longer be doubted that the absence of specified standards will produce ambiguity. The courts are surely in no position today, if ever they were in such a position, to delineate and apply accounting principles. Apart from the obvious point that courts consist of lawyers, not accountants, and that the lawyer's professional competence does not extend to accounting [49], there is the even larger issue that financial statements are the products of an extensive and complex set of processes. If, for example, a court should decide that current valuation of assets is an appropriate standard for testing the legality of corporate and partnership distributions, how will the court apply that standard? The accounting profession, facing a similar problem in dealing with inflation, has had the greatest difficulty in developing an approach to current valuation; and the firms faced with generating financial statements under the experimental rules promulgated by the Financial Accounting Standards Board have widely complained of the complexity of adjusting their GAAP statements to reflect the alternative reporting approach [50]. If the accounting profession and the reporting companies themselves experience this level of difficulty in developing financial statements based on principles different from GAAP, is it reasonable to expect that a court, or a corporate board of directors, will be able with confidence to evaluate the legality of distributions made under such alternative standards? As a leading commentator noted nearly twenty years ago:

"It is believed that the difficulties to a court of law in abandoning the accounting approach to asset valuation are enormous and little recognized. It will be seen, for example, that it is"
not simply a question of taking the accountant's balance sheet and adding unrealized appreciation. Virtually every single book entry going to make up the entire balance sheet would be subject to challenge and adjustment [51].

Another troublesome issue is created by prevailing choice-of-law rules, under which the law of the state of organization generally governs internal affairs. In general, a corporation organized in State “A” will be governed by the dividend statute of State “A” even if its business – and the distribution itself – is primarily centered in another state. Therefore, an adroit corporate planner can choose as the state of incorporation a state that has the most favorable rules [52]. Distribution rules rarely rise to the importance of governing the choice of the original state of incorporation. However, if a major transaction – such as redemption of a significant shareholder – cannot safely be implemented under the laws currently applicable to a corporation, counsel may advise reincorporation in a state where the laws are clearer and more favorable. This argument, unfortunately, proves a great deal: the literature detailing the “Gresham’s Law of Corporations” [53] is extensive and familiar [54]. My point here, however, is somewhat different. I appreciate the argument, made by several thoughtful commentators, that sharply restrictive state laws on distributions will ultimately prove ineffective [55]. It is important to realize, however, that liberal but ambiguous laws with respect to any area requiring business planning may be equally objectionable, and will similarly be avoided by those with the wit and resources to do so.

Ambiguity in the governing laws may also have a rebound effect, causing confusion with respect to the accountant’s reporting with respect to the enterprise. To the extent that legal rules govern permissibility of corporate distributions, they represent a legal interpretation of the corporate or partnership capital accounts. Although accountants have not been entirely constrained by legal capital rules [56], the tendency to look to legal definitions for accounting characterization remains.

4. Adoption of GAAP in state laws

4.1. The arguments summarized and evaluated

The principal argument against adoption of GAAP in state laws is that GAAP represent a changing set of standards, subject to constant revision and change, and themselves open to ambiguity. As noted above, this argument is a variant of the perfect being the enemy of the good. Revision, change and some ambiguity will be characteristic of any set of standards; GAAP provide a reasonably ascertainable set of standards from time to time, with a considerably narrower range of doubt than any other alternative. The ability to rely upon GAAP would provide counsel and business planners a basis for exercise
of informed business judgment. Arguments based on policy – that certain legal tests should rest on principles other than GAAP – can be answered directly by excepting those tests from the general application of GAAP.

On policy grounds one might argue that GAAP should not be applied since cost-based accounting is unreflective of real asset values and real enterprise performance. Whatever the merit of this argument, the difficulty of generating financial statements on a current value or adjusted cost basis suggests that legal adoption of such a principle might best await the development of a coherent set of accounting principles on the subject.

On the other hand, it has been suggested that legislative adoption of GAAP might itself have a constritive effect on the development of accounting principles. For example, state laws governing dividend distributions would undergo vast substantive changes if GAAP embraced the principle of current-value accounting. Representatives of various corporate constituencies, most notably creditors, might well lobby against such an adoption of accounting principles based on the legal effects that the change would cause [57]. The legal problem could, however, be separately addressed by specific legislation, rather than by insistence upon unchanged accounting principles.

There remain those who would argue that the ultimate decisions on application of legal standards must rest with the courts, and that delegation of rule-making to an outside authority (such as the FASB) is inappropriate as a matter of policy, and perhaps illegal as well. The argument based on delegation of rule-making authority does not appear to be well founded; recently it was rejected at the federal level with respect to the SEC's position that FASB Statements shall have substantial authoritative support [58]. The ultimate argument, namely that application of legal standards must remain with the courts, has merit to the extent that the standard is truly legal. However, when the principles to be applied are beyond the professional training and competence of lawyers, there is little basis for removing the standard-setting from the accountants merely because the forum where compliance will be evaluated is the courtroom.

4.2. Approaches to statutory implementation

Complexities in state policies with respect to corporations and partnerships make it unlikely that blanket adoption of GAAP in the governing statutes would be desirable. At this writing, no provision flatly adopting GAAP is in effect in the corporation or partnership laws of any state. The most inclusive approach to statutory standard-setting is the California General Corporation Law, which adopts GAAP "subject to any specific accounting treatment required by a particular section" of the Law [59]. At the other extreme, selective adoption of GAAP with respect to particular matters governed by a given law – such as determination of legality of cash dividends, or permissible
director reliance on financial statements — provides considerable clarification of applicable standards [60]. To the extent that the application of alternative standards, such as current fair market value, is adopted as state policy, the statute can so provide explicitly [61].

Notes

[4] See ALI-ABA, Model Business Corporation Act § 45 (Rev., 1980) [hereinafter cited as MBCA]; ALI-ABA, Revised Model Business Corporation Act § 6.40 (1984) [hereinafter cited as Revised MBCA]. The changes in the financial provisions of the MBCA were proposed in 1979, see MBCA Amendments, supra note 1, and were adopted in 1980, see Report of Committee on Corporate Laws, 35 Bus. Law. 1365 (1980). To date, the revised financial provisions have not been adopted in any state that has adopted the MBCA. In 1984, a complete revision of the MBCA, the Revised MBCA, was adopted, with essentially the same financial provisions. To date, no jurisdiction has adopted the Revised MBCA.
[7] See, e.g., Cal. Corp. Code § 114 (West Supp. 1985): All references in this division to financial statements, balance sheets, income statements and statements of changes in financial position of a corporation and all references to assets, liabilities, earnings, retained earnings and similar accounting items of a corporation mean such financial statements or such items prepared or determined in conformity with generally accepted accounting principles then applicable, fairly presenting in conformity with generally accepted accounting principles the matters which they purport to present, subject to any specific accounting treatment required by a particular section of this division.

Other less inclusive adoptions of GAAP include Mich. Comp. Laws Ann. § 450-1110 (West 1973) (total value of assets may be determined on the basis of book value in accordance with GAAP or at current fair market value); Md. Corps. & Ass’n Code Ann. § 1-402 (1985) (determinations concerning financial position are prima facie proper if made in good faith in accordance with
"generally accepted accounting practices and principles"); N.C. Gen. Stat. § 55-49(b) (1982) (granting permission to carry assets on the books in accordance with "generally accepted principles of sound accounting practice applicable to the kind of business conducted by the corporation").

7 A comprehensive discussion and evaluation of state dividend laws prior to the most recent amendments appears in Zeff, Legal Dividend Sources – A National Survey and Critique, N.Y. Certified Pub. Acct 741, 802 (Nov., Dec. 1961). Many of the formulations and terminological problems discussed by Zeff remain on the statute books.


11 See Del. Code Ann. tit. 8, §§ 154, 170 (1983) which limits dividends to "surplus," incorporating both accounting concepts "earned surplus" and "capital surplus." The MBCA, though limiting unrestricted declarations of dividends to "earned surplus," permits dividends also to the extent of "capital surplus" upon a vote of the shareholders. See MBCA § 46.


16 See Revised MBCA § 6.40.

17 See generally Manning, supra note 1.


19 See Revised MBCA § 6.40.

20 Cal. Corp. Code § 500 provides that a corporation shall not make a distribution unless one of two alternative tests is satisfied. The first is that the amount of the retained earnings of the corporation is at least equal to the amount of the distribution. Alternatively, the distribution is permitted if immediately after giving effect thereto:

(1) The sum of the assets of the corporation (exclusive of goodwill, capitalized research and development expenses and deferred charges) would be at least equal to 1 1/4 times its liabilities (not including deferred taxes, deferred income and other deferred credits); and (2) The current assets of the corporation would be at least equal to its current liabilities [or, in certain circumstances 1 1/4 times current liabilities].

21 See supra note 20.


23 See MBCA § 45; Revised MBCA § 6.40.

24 See infra; notes 40–42 and accompanying text.

25 ULPA § 10(2).

26 RULPA § 607.


28 As of May 1, 1985, no reported opinions interpret this provision or its use of the phrase "fair value."
[31] Typical of the director liability provisions is MBCA § 48:

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.

Any director against whom a claim shall be asserted under or pursuant to this section ... shall be entitled to contribution from the shareholders who accepted or received any such distribution, knowing such distribution to have been made in violation of this Act....

[33] Id. at 87–88.
[34] RULPA § 607.

[37] MBCA § 45; revised MBCA § 6.40.
[38] MBCA § 45; revised MBCA § 6.40.
[40] Compare Cal. Corp. Code § 500 (West Supp. 1985) (discussed supra at note 20) with MBCA § 45. The California statute, which was drafted before adoption of the Model Act revisions and which in large part inspired the new Model Act provisions, also contains an insolvency test. Cal. Corp. Code § 501 (West 1977). California opted to retain the longstanding accounting test of retained earnings, and as an alternate test, California permits distributions to be made upon a balance sheet evaluation. Cal. Corp. Code § 500 (West Supp. 1985). However, instead of a bare-bones assets-in-excess-of-liabilities criterion, Cal. Corp. Code § 500 provides two additional levels of creditor protection: assets must exceed liabilities by 25%, and current assets must exceed current liabilities (as defined). Furthermore, in some instances based on prior corporate performance, current assets must exceed current liabilities by 25%.

[41] A recent task force report considers the question whether the insolvency test for corporate distributions should completely replace all accounting tests, including the minimal balance sheet tests retained in the Revised Model Act. The report is inconclusive, but it appears quite unlikely that any legislature will remove all accounting criteria for distributions. See Current Issues on the Legality of Dividends from a Law and Accounting Perspective: A Task Force Report, 39 Bus. Law. 289, 303–06 (1983).

[42] I.R.C. § 168 (1954), as amended by the Economic Recovery Tax Act of 1981 (ERTA) (I.R.C. § 168 (1985)), introduced highly-accelerated depreciation tables for fixed assets as part of a legislative attempt to spur capital expenditures in a period of economic stagnation. Examples of the short depreciation periods include equipment, to be written off over a period of three or five years, and most depreciable real estate, to be depreciated over a period of fifteen years. In 1984, when economic priorities had shifted, the real estate depreciation period was extended to eighteen years by the Tax Reform Act of 1984 (I.R.C. § 168 (1985)). No suggestion was made in either act that the periods chosen reflected the useful lives of the assets involved under GAAP.

[44] See supra note 33.
[45] The pre-revision MBCA retains the term "earned surplus," and that term remains in most state dividend statutes to this day. See MBCA § 45. Some thirty years ago, the accounting profession replaced this term with "retained earnings." See Committee on Terminology, Acc't Terminology Bull. No. 1, ¶¶ 65–70 (1953).

[46] See MBCA Amendments, supra note 1, at 1884.

[47] The leading article is Herwitz, Installment Repurchase of Stock: Surplus Limitations, 79 Harv. L. Rev. 303 (1965). The principal question, unresolved by the language of most statutes, is whether the test for distribution must be met at the outset (upon incurrence of the installment obligation) or as of the payment of each installment, or -- perhaps -- at both times. This question is further complicated by the presence in the statutes of two or more standards, e.g., surplus and solvency. Sound arguments have been made that different standards are applicable at different times.

[48] The revisions of the MBCA added the following section:

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

MBCA § 2(i). The drafters' comments state that in the case of an installment repurchase of shares, the incurrence of the debt constitutes the distribution. See MBCA Amendments, supra note 1, at 1878. Accordingly, the MBCA balance sheet and solvency tests must be satisfied as of that date. MBCA § 45 further reinforces this position. The same standards are found in Revised MBCA § 6.40.

California takes a somewhat different approach, which may in some instances offer planning advantages:

The time of any distribution by purchase or redemption of shares shall be the date cash or property is transferred by the corporation, whether or not pursuant to a contract of an earlier date; provided, that where a negotiable debt security ... is issued in exchange for shares the time of the distribution is the date when the corporation acquires the shares in such exchange.

Cal. Corp. Code § 166. The presumptive rule adopted by California is, therefore, the opposite of the MBCA rule: the distribution is tested as of each payment. However, California leaves open the possibility, by using a negotiable debt security, of applying the distribution test at the outset. In cases where the obligation to be undertaken is substantial, the presumptive California rule may prove less restrictive than the MBCA rule.

[49] "The law has generally been unwilling to recognize that accountants are experts in accounting and lawyers and courts are not." 2 H. Marsh, California Corporation Law & Practice 13.7 (1981).


[52] Not all states, however, have abstained completely from the application of their corporate laws to the operations of corporations incorporated elsewhere. Thus, certain non-California corporations doing business and having shareholders within the state will be subject to various California rules, including those concerning distributions. See Cal. Corp. Code § 2115.

[53] Gresham's law states that currency with a greater intrinsic value will be hoarded while currency with the same face value circulates more freely. See, e.g., C. Ammer & D. Ammer, Dictionary of Business and Economics (2d ed. 1984).

[S]eeing to attract corporations to establish their domiciles within their borders, most states in recent decades have been increasingly flexible and permissive in revising their corporation laws.

Pursuing this policy perhaps further than any other state, the Commission believes it is following sound public policy for New Jersey. It is clear that the major protections to investors, creditors, employees, customers, and the general public have come, and must continue to come, from Federal legislation and not from state corporation acts.


[55] See generally MBCA Amendments, supra note 1; Manning, supra note 1, at 109–10.

[56] For example, GAAP requires that stock dividends be accounted for by transferring the fair market value of the new shares issued from retained earnings. By contrast, most state corporation statutes would appear to require only that the stated capital of the new shares be transferred out of surplus. See, e.g., MBCA § 45(d); Del. Code Ann. tit. 8, § 173 (1983); N.Y. Bus. Corp. Law § 511 (McKinney 1963 and Supp. 1984).

[57] For this insight, I am indebted to Prof. Stephen Zeff, who, however, may not agree with my response to the problem.


[60] See statutes cited supra note 7.


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