

/\* The Business Corporations Act continues. This is part 2 out of 8. \*/

(c) Shares issued pursuant to subscriptions entered into before incorporation are fully paid and nonassessable when the corporation receives the consideration specified in the subscription agreement.

(d) If a subscriber defaults in payment of money or property under a subscription agreement entered into before incorporation, the corporation may collect the amount owed as any other debt. Alternatively, unless the subscription agreement provides otherwise, the corporation may rescind the agreement and may sell the shares if the debt remains unpaid more than 20 days after the corporation sends written demand for payment to the subscriber.

(e) A subscription agreement entered into after incorporation is a contract between the subscriber and the corporation subject to section 6.21.

#### Official Comment

Agreements for the purchase of shares to be issued by a corporation are typically referred to as "subscriptions" or "subscription agreements." Section 6.20 deals exclusively with preincorporation subscriptions, that is, subscriptions entered into before the corporation was formed. Preincorporation subscriptions have often been considered to be revocable offers rather than binding contracts. Since the corporation is not in existence, it cannot be a party to the agreement and the consideration established for the shares is not determined by the board of directors. While preincorporation subscriptions entered into simultaneously by several subscribers may be considered a binding contract between or among the subscribers, not all factual situations lend themselves to contractual analysis. Because of the uncertainty of the legal enforceability of these transactions, section 6.20 provides a simple set of legal rules applicable to the enforcement of preincorporation subscriptions by the corporation after its formation. It does not address the extent to which preincorporation subscriptions may constitute a contract between or among subscribers, and other subscribers may enforce whatever contract rights they have without regard to section 6.20.

Section 6.20(a) provides that preincorporation subscriptions are irrevocable for six months unless the subscription agreement provides that they are revocable or that they are irrevocable for some other period. Nevertheless, all the subscribers to shares may agree at any time that a subscriber may withdraw in part from his commitment to subscribe for shares, that a subscriber may revoke his subscription entirely, or that the period of irrevocability may continue for an additional stated period. If the corporation accepts the subscription during the period of irrevocability, the subscription becomes a contract binding on both the subscribers and the corporation. The terms of this contract are set forth in sections 6.20(b) and (d). . .

Postincorporation subscriptions are contracts between the corporation and the investor by which the corporation agrees to issue shares for a stated consideration and the investor agrees to purchase the shares for that consideration. Postincorporation subscriptions are simple contracts subject to the power of the board of directors and they may contain any mutually acceptable provisions subject to section 6.21. Section 6-20(e) states, for completeness, that postincorporation subscriptions are contracts between the corporation and the subscriber subject to section 6.21.

## 6.21 Issuance of Shares

(a) The powers granted in this section to the board of directors may be reserved to the shareholders by the articles of incorporation.

(b) The board of directors may authorize shares to be issued for consideration consisting of any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation.

/\* Many previous Business Corporations Acts do not permit shares to be executed for promises for later services. \*/

(c) Before the corporation issues shares, the board of directors must determine that the consideration received or to be received for shares to be issued is adequate. That determination by the board of directors is conclusive insofar as the adequacy of consideration for the issuance of shares relates to whether the shares are validly issued, fully paid, and nonassessable.

(d) When the corporation receives the consideration for which the board of directors authorized the issuance of shares, the shares issued therefor are fully paid and nonassessable.

(e) The corporation may place in escrow shares issued for a contract for future services or benefits or a promissory note, or make other arrangements to restrict the transfer of the shares, and may credit distributions in respect of the shares against their purchase price, until the services are performed, the note is paid, or the benefits received. If the services are not performed, the note is not paid, or the benefits are not received, the shares escrowed or restricted and the distributions credited may be cancelled in whole or part.

## Official Comment

The financial provisions of the Model Act reflect a modernization of the concepts underlying the capital structure and limitations on distributions of corporations. This process of modernization began with amendments in 1980 to the 1969 Model Act that eliminated the concepts of "par value" and "stated

capital," and further modernization occurred in connection with the development of the revised Act in 1984. Practitioners and legal scholars have long recognized that the statutory structure embodying "par value" and "legal capital" concepts is not only complex and confusing but also fails to serve the original purpose of protecting creditors and senior security holders from payments to junior security holders. Indeed, to the extent security holders are led to believe that it provides this protection, these provisions may be affirmatively misleading. The Model Act has therefore eliminated these concepts entirely and substituted a simpler and more flexible structure that provides more realistic protection to these interests. Major aspects of this new structure are:

(1) the provisions relating to the issuance of shares set forth in this and the following sections:

(2) the provisions limiting distributions by corporations set forth in section 6.40 and discussed in the Official Comment to that section; and

(3) the elimination of the concept of treasury shares described in the Official Comment to section 6.31. Section 6.21 incorporates not only the elimination of the concepts of par value and stated capital from the Model Act in 1980 but also eliminates the earlier rule declaring certain kinds of property ineligible as consideration for shares. .

Since shares need not have a par value, under section 6.21 there is no minimum price at which specific shares must be issued and therefore there can be no "watered stock" liability for issuing shares below an arbitrarily fixed price. The price at which shares are issued is primarily a matter of concern to other shareholders whose interests may be diluted if shares are issued at unreasonably low prices or for overvalued property. This problem of equality of treatment essentially involves honest and fair judgments by directors and cannot be effectively addressed by an arbitrary doctrine establishing a minimum price for shares such as "par value" provided under older statutes.

Section 6.21(b) specifically validates contracts for future services (including promoters' services), promissory notes, or "any tangible or intangible property or benefit to the corporation," as consideration for the present issue of shares. The term "benefit" should be broadly construed to include, for example, a reduction of a liability, a release of a claim, or benefits obtained by a corporation by contribution of its shares to a charitable organization or as a prize in a promotion. In the realities of commercial life there is sometimes a need for the issuance of shares for contract rights or such intangible property or benefits. And, as a matter of business economics, contracts for future services, promissory notes, and intangible property or benefits often have value that is as real as the value of tangible property or past services, the only types of property that many older statutes permit as consideration for

shares. Thus, only business judgment should determine what kind of property should be obtained for shares, and a determination by the directors meeting the requirements of section 8.30 to accept a specific kind of valuable property for shares should be accepted and not circumscribed by artificial or arbitrary rules.

The issuance of some shares for cash and other shares for promissory notes, contracts for past or future services, or for tangible or intangible property or benefits, like the issuance of shares for an inadequate consideration, opens the possibility of dilution of the interests of other shareholders. For example, persons acquiring shares for cash may be unfairly treated if optimistic values are placed on past or future services or intangible benefits being provided by other persons. The problem is particularly acute if the persons providing services, promissory notes, or property or benefits of debatable value are themselves connected with the promoters of the corporation or with its directors. Protection of shareholders against abuse of the power granted to the board of directors to determine that shares should be issued for intangible property or benefits is provided in part by the requirement that the board must act in accordance with the requirements of section 8.30, and, if applicable, section 8.31, in determining that the consideration received for shares is adequate, and in part by the requirement of section 16.21 that the corporation must inform all shareholders annually of all shares issued during the previous year for promissory notes or promises of future services.

Accounting principles are not specified in the Model Act, and the board of directors is not required by the statute to determine the "value" of noncash consideration received by the corporation (as was the case in earlier versions of the Model Act). In many instances, property or benefit received by the corporation will be of uncertain value; if the board of directors determines that the issuance of shares for the property or benefit is an appropriate transaction that protects the shareholders from dilution, that is sufficient under section 6.21. The board of directors does not have to make an explicit "adequacy" determination by formal resolution; that determination may be inferred from a determination to authorize the issuance of shares for a specified consideration.

Section 6.21 also does not require that the board of directors determine the value of the consideration to be entered on the books of the corporation, though the board of directors may do so if it wishes. Of course, a specific value must be placed on the consideration received for the shares for bookkeeping purposes, but bookkeeping details are not the statutory responsibility of the board of directors. The statute also does not require the board of directors to determine the corresponding entry on the right-hand side of the balance sheet under owner's equity to be designated as "stated capital" or be allocated among "stated capital" and other surplus accounts. The corporation, however, may determine that the shareholders' equity accounts should be divided into these traditional categories if it wishes.

The second sentence of section 6.21(c) describes the effect of the determination by the board of directors that consideration is adequate for the issuance of shares. That determination, without more, is conclusive to the extent that adequacy is relevant to the question whether the shares are validly issued, fully paid, and nonassessable. Section 6.21(c) provides that shares are fully paid and nonassessable when the corporation receives the consideration for which the board of directors authorized their issuance. Whether shares are validly issued may depend on compliance with corporate procedural requirements, such as issuance within the amount authorized in the articles of incorporation or holding a directors' meeting upon proper notice and with a quorum present. The Model Act does not address the remedies that may be available for issuances that are subject to challenge. . .

The revised Model Act does not address the question whether validly issued shares may thereafter be cancelled on the grounds of fraud or bad faith if the shares are in the hands of the original shareholder or other persons who were aware of the circumstances under which they were issued when they acquired the shares. It also leaves to the Uniform Commercial Code other questions relating to the rights of persons other than the person acquiring the shares from the corporation. . .

## 6.22 Liability of Shareholders

(a) A purchaser from a corporation of its own shares is not liable to the corporation or its creditors with respect to the shares except to pay the consideration for which the shares were authorized to be issued (section 6.21) or specified in the subscription agreement (section 6.20).

(b) Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.

## 6.23 Share Dividends

(a) Unless the articles of incorporation provide otherwise, shares may be issued pro rata and without consideration to the corporation's shareholders or to the shareholders of one or more classes or series. An issuance of shares under this subsection is a share dividend.

(b) Shares of one class or series may not be issued as a share dividend in respect of shares of another class or series unless (1) the articles of incorporation so authorize, (2) a majority of the votes entitled to be cast by the class or series to be issued approve the issue, or (3) there are no outstanding shares of the class or series to be issued.

(c) If the board of directors does not fix the record date for determining shareholders entitled to a share dividend, it is the date the board of directors authorizes the share dividend.

#### Official Comment

A share dividend is solely a paper transaction: No assets are received by the corporation for the shares and any "dividend" paid in shares does not involve the distribution of property by the corporation to its shareholders. Section 6.23 therefore recognizes that such a transaction involves the issuance of shares "without consideration," and section 1.40(6) excludes it from the definition of a Such transactions were treated in a fictional way under the old "par value" and "stated capital" statutes, which treated a share dividend as involving transfers from a surplus account to stated capital and assumed that par value shares could be issued without receiving any consideration by reason of that transfer of surplus.

The par value statutory treatment of share dividend transactions distinguished a share "split" from a dividend. In a share "split" the par value of the former shares was divided among the new shares and there was no transfer of surplus into the stated capital account as in the case of a share "dividend." Since the Model Act has eliminated the concept of par value, the distinction between a "split" and a "dividend" has not been retained and both types of transactions are referred to simply as "share dividends." A distinction between "share dividends" and "share splits." however, continues to exist in other contexts—for example, in connection with transactions by publicly held corporations, see N.Y.S.E. Listed Company Manual 703.02(a), or corporations that have optionally retained par value for their shares. The change made in the Model Act is not intended to affect the manner in which transactions by these corporations are handled or described but simply reflects the elimination of artificial legal distinctions based on the par value statutes . . .

#### 6.24 Share Options

A corporation may issue rights, options, or warrants for the purchase of shares of the corporation. The board of directors shall determine the terms upon which the rights, options, or warrants are issued, their form and content, and the consideration for which the shares are to be issued.

#### 6.25 Form and Content of Certificates

(a) Shares may but need not be represented by certificates. Unless this Act or another statute expressly provides otherwise, the rights and obligations of shareholders are identical whether or not their shares are represented by certificates.

(b) At a minimum each share certificate must state on its face:

(1) the name of the issuing corporation and that it is organized under the law of this state;

(2) the name of the person to whom issued; and

(3) the number and class of shares and the designation of the series, if any, the certificate represents.

(c) If the issuing corporation is authorized to issue different classes of shares or different series within a class, the designations, relative rights, preferences, and limitations applicable to each class and the variations in rights, preferences, and limitations determined for each series (and the authority of the board of directors to determine variations for future series) must be summarized on the front or back of each certificate. Alternatively, each certificate may state conspicuously on its front or back that the corporation will furnish the shareholder this information on request in writing and without charge.

(d) Each share certificate (1) must be signed (either manually or in facsimile) by two officers designated in the bylaws or by the board of directors and (2) may bear the corporate seal or its facsimile.

(e) If the person who signed (either manually or in facsimile) a share certificate no longer holds office when the certificate is issued, the certificate is nevertheless valid.

#### 6.26 Shares Without Certificates

(a) Unless the articles of incorporation or bylaws provide otherwise, the board of directors of a corporation may authorize the issue of some or all of the shares of any or all of its classes or series without certificates. The authorization does not affect shares already represented by certificates until they are surrendered to the corporation.

/\* Thus the shares can be represented by electronic or other book transactions. \*/

(b) Within a reasonable time after the issue or transfer of shares without certificates, the corporation shall send the shareholder a written statement of the information required on certificates by section 6.25(b) and (c), and, if applicable, section 6.27.

#### 6.27 Restriction on Transfer of Shares and Other Securities

(a) The articles of incorporation, bylaws, an agreement among shareholders, or an agreement between shareholders and the corporation may impose restrictions on the transfer or registration of transfer of shares of the corporation. A restriction does not affect shares issued before the restriction

was adopted unless the holders of the shares are parties to the restriction agreement or voted in favor of the restriction.

(b) A restriction on the transfer or registration of transfer of shares is valid and enforceable against the holder or a transferee of the holder if the restriction is authorized by this section and its existence is noted conspicuously on the front or back of the certificate or is contained in the information statement required by section 6.26(b). Unless so noted, a restriction is not enforceable against a person without knowledge of the restriction.

(c) A restriction on the transfer or registration of transfer of shares is authorized:

(1) to maintain the corporation's status when it is dependent on the number or identity of its shareholders;

(2) to preserve exemptions under federal or state securities law;

(3) for any other reasonable purpose.

(d) A restriction on the transfer or registration of transfer of shares may:

(1) obligate the shareholder first to offer the corporation or other persons (separately, consecutively, or simultaneously) an opportunity to acquire the restricted shares;

(2) obligate the corporation or other persons (separately, consecutively, or simultaneously) to acquire the restricted shares;

(3) require the corporation, the holders of any class of its shares, or another person to approve the transfer of the restricted shares, if the requirement is not manifestly unreasonable;

(4) prohibit the transfer of the restricted shares to designated persons or classes of persons, if the prohibition is not manifestly unreasonable.

(e) For purposes of this section, "shares" includes a security convertible into or carrying a right to subscribe for or acquire shares.

## 6.28 Expense of Issue

A corporation may pay the expenses of selling or underwriting its shares, and of organizing or reorganizing the corporation, from the consideration received for shares.

## Subchapter C

## Subsequent Acquisition of Shares by Shareholders and Corporation



### 6.30 Shareholders' Preemptive Rights

(a) The shareholders of a corporation do not have a preemptive right to acquire the corporation's unissued shares except to the extent the articles of incorporation so provide.

(b) A statement included in the articles of incorporation that "the corporation elects to have preemptive rights" (or words of similar import) means that the following principles apply except to the extent the articles of incorporation expressly provide otherwise:

(1) The shareholders of the corporation have a preemptive right, granted on uniform terms and conditions prescribed by the board of directors to provide a fair and reasonable opportunity to exercise the right, to acquire proportional amounts of the corporation's unissued shares upon the decision of the board of directors to issue them.

/\* Pre-emptive rights are those which allow shareholders to purchase shares more shares of the corporation if they are issued, so to maintain their equity/ \*/

(2) A shareholder may waive his preemptive right. A waiver evidenced by a writing is irrevocable even though it is not supported by consideration.

(3) There is no preemptive right with respect to:

(i) shares issued as compensation to directors, officers, agents, or employees of the corporation, its subsidiaries or affiliates;

(ii) shares issued to satisfy conversion or option rights created to provide compensation to directors, officers, agents, or employees of the corporation, its subsidiaries or affiliates;

(iii) shares authorized in articles of incorporation that are issued within six months from the effective date of incorporation;

(iv) shares sold otherwise than for money.

(4) Holders of shares of any class without general voting rights but with preferential rights to distributions or assets have no preemptive rights with respect to shares of any class.

(5) Holders of shares of any class with general voting rights but without preferential rights to distributions or assets have no preemptive rights with respect to shares of any class with preferential rights to distributions or assets unless the shares with preferential rights are convertible into or carry a right to subscribe for or acquire shares without preferential rights.

(6) Shares subject to preemptive rights that are not acquired by shareholders may be issued to any person for a period of one year

after being offered to shareholders at a consideration set by the board of directors that is not lower than the consideration set for the exercise of preemptive rights. An offer at a lower consideration or after the expiration of one year is subject to the shareholders' preemptive rights.

(c) For purposes of this section, "shares" includes a security convertible into or carrying a right to subscribe for or acquire shares.

## Subchapter D

### Distributions

#### 6.40 Distributions to Shareholders

(a) A board of directors may authorize and the corporation may make distributions to its shareholders subject to restriction by the articles of incorporation and the limitation in subsection (c).

(b) If the board of directors does not fix the record date for determining shareholders entitled to a distribution (other than one involving a purchase, redemption, or other acquisition of the corporation's shares), it is the date the board of directors authorizes the distribution.

(c) No distribution may be made if, after giving it effect:

(1) the corporation would not be able to pay its debts as they become due in the usual course of business; or

/\* The equity definition of bankruptcy. \*/

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

/\* The legal definition of bankruptcy. The combined effect of these sections is to prevent distributions when the effect is to result in financial instability of the corporation. \*/

(d) The board of directors may base a determination that a distribution is not prohibited under subsection (c) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.

(e) Except as provided in subsection (g), the effect of a distribution under subsection (c) is measured:

(1) in the case of distribution by purchase, redemption, or other acquisition of the corporation's shares, as of the earlier of (i) the date money or other property is transferred or debt incurred by the corporation or (ii) the date the shareholder ceases to be a shareholder with respect to the acquired shares;

(2) in the case of any other distribution of indebtedness, as of the date the indebtedness is distributed; and

(3) in all other cases, as of (i) the date the distribution is authorized if the payment occurs within 120 days after the date of authorization or (ii) the date the payment is made if it occurs more than 120 days after the date of authorization.

(f) A corporation's indebtedness to a shareholder incurred by reason of a distribution made in accordance with this section is at parity with the corporation's indebtedness to its general, unsecured creditors except to the extent subordinated by agreement.

(g) Indebtedness of a corporation, including indebtedness issued as a distribution, is not considered a liability for purposes of determinations under subsection (c) if its terms provide that payment of principal and interest are made only if and to the extent that payment of a distribution to shareholders could then be made under this section. If the indebtedness is issued as a distribution, each payment of principal or interest is treated as a distribution, the effect of which is measured on the date the payment is actually made.

#### Official Comment

The reformulation of the statutory standards governing distributions is another important change made by the 1980 revisions to the financial provisions of the Model Act. It has long been recognized that the traditional "par value" and "stated capital" statutes do not provide significant protection against distributions of capital to shareholders. While most of these statutes contained elaborate provisions establishing "stated capital," "capital surplus," and "earned surplus" (and often other types of surplus as well), the net effect of most statutes was to permit the distribution to shareholders of most or all of the corporation's net assets- its capital along with its earnings- if the shareholders wished this to be done. However, statutes also generally imposed an equity insolvency test on distributions that prohibited distributions of assets if the corporation was insolvent or if the distribution had the effect of making the corporation insolvent or unable to meet its obligations as they were projected to arise.

The financial provisions of the revised Model Act, which are based on the 1980 amendments, sweep away all the distinctions among the various types of surplus but retain restrictions on

distributions built around both the traditional equity insolvency and balance sheet tests of earlier statutes.

## 1. The Scope of Section 6.40

Section 1.40 defines "distribution" to include virtually all transfers of money, indebtedness of the corporation or other property to a shareholder in respect of the corporation's shares. It thus includes cash or property dividends, payments by a corporation to purchase its own shares, distributions of promissory notes or indebtedness, and distributions in partial or complete liquidation or voluntary or involuntary dissolution. Section 1.40 excludes from the definition of "distribution" transactions by the corporation in which only its own shares are distributed to its shareholders. These transactions are called "share dividends" in the revised Model Business Corporation Act. See section 6.23.

Section 6.40 imposes a single, uniform test on all distributions. Many of the old "par value" and "stated capital" statutes provided tests that varied with the type of distribution under consideration or did not cover certain types of distributions at all.

## 2. Equity Insolvency Test

As noted above, older statutes prohibited payments of dividends if the corporation was, or as a result of the payment would be, insolvent in the equity sense. This test is retained, appearing in section 6.40(c) (1).

In most cases involving a corporation operating as a going concern in the normal course, information generally available will make it quite apparent that no particular inquiry concerning the equity insolvency test is needed. While neither a balance sheet nor an income statement can be conclusive as to this test, the existence of significant shareholders' equity and normal operating conditions are of themselves a strong indication that no issue should arise under that test. Indeed, in the case of a corporation having regularly audited financial statements, the absence of any qualification in the most recent auditor's opinion as to the corporation's status as a "going concern," coupled with a lack of subsequent adverse events, would normally be decisive.

It is only when circumstances indicate that the corporation is encountering difficulties or is in an uncertain position concerning its liquidity and operations that the board of directors or, more commonly, the officers or others upon whom they may place reliance under section 8.30(b), may need to address the issue. Because of the overall judgment required in evaluating the equity insolvency test, no one or more "bright line" tests can be employed. However, in determining whether the equity insolvency test has been met, certain judgments or assumptions as to the future course of the corporation's business are customarily justified, absent clear evidence to the contrary.

These include the likelihood that (a) based on existing and contemplated demand for the corporation's products or services, it will be able to generate funds over a period of time sufficient to satisfy its existing and reasonably anticipated obligations as they mature, and (b) indebtedness which matures in the near-term will be refinanced where, on the basis of the corporation's financial condition and future prospects and the general availability of credit to businesses similarly situated, it is reasonable to assume that such refinancing may be accomplished. To the extent that the corporation may be subject to asserted or unasserted contingent liabilities, reasonable 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 against loss, may be utilized. There may be occasions when it would be useful to consider a cash flow analysis, based on a business forecast and budget, covering a sufficient period of time to permit a conclusion that known obligations of the corporation can reasonably be expected to be satisfied over the period of time that they will mature.

In exercising their judgment, the directors are entitled to rely, under section 8.30(b) as noted above, on information, opinions, reports, and statements prepared by others. Ordinarily, they should not be expected to become involved in the details of the various analyses or market or economic projections that may be relevant. Judgments must of necessity be made on the basis of information in the hands of the directors when a distribution is authorized. They should not, of course, be held responsible as a matter of hindsight for unforeseen developments. This is particularly true with respect to assumptions as to the ability of the corporation's business to repay long-term obligations which do not mature for several years, since the primary focus of the directors decision to make a distribution should normally be on the corporation's prospects and obligations in the shorter term, unless special factors concerning the corporation's prospects require the taking of a longer term perspective.

### 3. Relationship to the Federal Bankruptcy Act and Other Fraudulent Conveyance Statutes

The revised Model Business Corporation Act establishes the validity of distributions from the corporate law standpoint under section 6.40 and determines the potential liability of directors for improper distributions under sections 8.30 and 8.33. The federal Bankruptcy Act and state fraudulent conveyance statutes, on the other hand, are designed to enable the trustee or other representative to recapture for the benefit of creditors funds distributed to others in some circumstances. In light of these diverse purposes, it was not thought necessary to make the tests of section 6.40 identical to the tests for insolvency under these various statutes.

### 4. Balance Sheet Test

Section 6.40(c)(2) requires that, after giving effect to any distribution, the corporation's assets equal or exceed its liabilities plus (with some exceptions) the dissolution preferences of senior equity securities. Section 6.40(d) authorizes asset and liability determinations to be made for this purpose on the basis of either (1) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or 2) a fair valuation or other method that is reasonable in the circumstances. The determination of a corporation's assets and liabilities and the choice of the permissible basis on which to do so are left to the judgment of its board of directors. In making a judgment under section 6.40 (d), the board may rely under section 8.30 upon opinions, reports, or statements, including financial statements and other financial data prepared or presented by public accountants or others.

Section 6.40 does not utilize particular accounting terminology of a technical nature or specify accounting concepts. In making determinations under this section, the board of directors may make judgments about accounting matters, giving full effect to its right to rely upon professional or expert opinion.

In a corporation with subsidiaries, the board of directors may rely on unconsolidated statements prepared on the basis of the equity method of accounting (see American Institute of Certified Public Accountants, APB Opinion No. 18 (1971)) as to the corporation's investee corporations, including corporate joint ventures and subsidiaries, although other evidence would be relevant in the total determination.

#### a. Generally Accepted Accounting Principles

The board of directors should in all circumstances be entitled to rely upon reasonably current financial statements prepared on the basis of generally accepted accounting principles in determining whether or not the balance sheet test of section 6.40(c)(2) has been met, unless the board is then aware that it would be unreasonable to rely on the financial statements because of newly-discovered or subsequently arising facts or circumstances. But section 6.40 does not mandate the use of generally accepted accounting principles; it only requires the use of accounting practices and principles that are reasonable in the circumstances. While publicly-owned corporations subject to registration under the Securities Exchange Act of 1934 must, and many other corporations in fact do, utilize financial statements prepared on the basis of generally accepted accounting principles, a great number of smaller or closely-held corporations do not. Some of these corporations maintain records solely on a tax accounting basis and their financial statements are of necessity prepared on that basis. Others prepare financial statements that substantially reflect generally accepted accounting principles but may depart from them in some

respects (e.g., footnote disclosure). These facts of corporate life indicate that a statutory standard of reasonableness, rather than stipulating generally accepted accounting principles as the normative standard, is appropriate in order to achieve a reasonable degree of flexibility and to accommodate the needs of the many different types of business corporations which might be subject to these provisions, including in particular closely-held corporations. Accordingly, the revised Model Business Corporation Act contemplates that generally acceptable accounting principles are always "reasonable in the circumstances" and that other accounting principles may be perfectly acceptable, under a general standard of reasonableness, even if they do not involve the "<fair value" or "<current value" concepts that are also contemplated by section 6.40(d).

#### b. Other Principles

Section 6.40(d) specifically permits determinations to be made under section 6.40(c)(2) on the basis of a fair valuation or other method that is reasonable in the circumstances. Thus the statute authorizes departures from historical cost accounting and sanctions the use of appraisal and current value methods to determine the amount available for distribution. No particular method of valuation is prescribed in the statute, since different methods may have validity depending upon the circumstances, including the type of enterprise and the purpose for which the determination is made. For example, it is inappropriate in most cases to apply a "quick-sale liquidation" method to value an enterprise, particularly with respect to the payment of normal dividends. On the other hand, a "quick-sale liquidation" valuation method might be appropriate in certain circumstances for an enterprise in the course of reducing its asset or business base by a material degree. In most cases, a fair valuation method or a going concern basis would be appropriate if it is believed that the enterprise will continue as a going concern.

Ordinarily a corporation should not selectively revalue assets. It should consider the value of all its material assets, whether or not reflected in the financial statements (e.g., a valuable executory contract). Likewise all of a corporation's material obligations should be considered and revalued to the extent appropriate and possible. In any event, section 6.40(d) calls for the application under section 6.40(c)(2) of a method of determining the aggregate amount of assets and liabilities that is reasonable in the circumstances.

Section 6.40(d) also refers to some "other method that is reasonable in the circumstances." This phrase is intended to comprehend within section 6.40(c)(2) the wide variety of possibilities that might not be considered to fall under a "fair valuation" or "current value" but might be reasonable in the circumstances of a particular case.

5. Preferential Dissolution Rights and the Balance Sheet Test  
Section 6.40(c)(2) provides that a distribution may not be made unless the total assets of the corporation exceed its liabilities plus the amount that would be needed to satisfy any shareholders' superior preferential rights upon dissolution if the corporation were to be dissolved at the time of the distribution. This requirement in effect treats preferential dissolution rights of shares for distribution purposes as if they were liabilities for the sole purpose of determining the amount available for distributions, and carries forward analogous treatment of shares having preferential dissolution rights from earlier versions of the Model Act. In making the calculation of the amount that must be added to the liabilities of the corporation to reflect the preferential dissolution rights, the assumption should be made that the preferential dissolution rights are to be established pursuant to the articles of incorporation, as of the date of the distribution or proposed distribution. The amount so determined must include arrearages in preferential dividends if the articles of incorporation or resolution require that they be paid upon the dissolution of the corporation. In the case of shares having both a preferential right upon dissolution and other nonpreferential rights, only the preferential right should be taken into account. The treatment of preferential dissolution rights of classes of shares set forth in section 6.40(c)(2) is applicable only to the balance sheet test and is not applicable to the equity insolvency test of section 6.40(c)(1). The treatment of preferential rights mandated by this section may always be eliminated by an appropriate provision in the articles of incorporation.

#### 6. Time of Measurement

Section 6.40(e)(3) provides that the time for measuring the effect of a distribution for compliance with the equity insolvency and balance sheet tests for all distributions not involving the reacquisition of shares or the distribution of indebtedness is the date of authorization, if the payment occurs within 120 days following the authorization; if the payment occurs more than 120 days after the authorization, however, the date of payment must be used. If the corporation elects to make a distribution in the form of its own indebtedness under section 6.40(e)(2) the validity of that distribution must be measured as of the time of distribution, unless the indebtedness qualifies under section 6.40(g).

Section 6.40(e)(1) provides a different rule for the time of measurement when the distribution involves a reacquisition of shares. See below, Application to Reacquisition of Shares-Time of measurement.

#### 7. Record Date

Section 6.40(b) fixes the record date (if the board of directors does not otherwise fix it) for distributions other than those involving a reacquisition of shares as the date the board of



directors authorizes the distribution. No record date is necessary for a reacquisition of shares from one or more specific shareholders. The board of directors has discretion to set a record date for a reacquisition if it is to be pro rata and to be offered to all shareholders as of a specified date.

## 8. Application to Reacquisition of Shares

The application of the equity insolvency and balance sheet tests to distributions that involve the purchase, redemption, or other acquisition of the corporation's shares creates unique problems; section 6.40 provides a specific rule for the resolution of these problems as described below.

### a. Time of Measurement

Section 6.40(e)(1) provides that the time for measuring the effect of a distribution under section 6.40(c), if shares of the corporation are reacquired, is the earlier of (i) the payment date, or (ii) the date the shareholder ceased to be a shareholder with respect to the shares, except as provided in section 6.40(g).

### b. When Tests Are Applied to Redemption-Related Debt

In an acquisition of its shares, a corporation may transfer property or incur debt to the former holder of the shares. The case law on the status of this debt is conflicting. However, share repurchase agreements involving payment for shares over a period of time are of special importance in closely-held corporate enterprises. Section 6.40(e) provides a clear rule for this situation: the legality of the distribution must be measured at the time of the issuance [or] incurrence of the debt, not at a later date when the debt is actually paid, except as provided in section 6.40(g). Of course, this does not preclude a later challenge of a payment on account of redemption-related debt by a bankruptcy trustee on the ground that it constitutes a preferential payment to a creditor.

### c. Priority of Debt Distributed Directly or Incurred in Connection With a Reacquisition of Shares

Section 6.40(f) provides that indebtedness created to acquire the corporation's shares or issued as a distribution is on a parity with the indebtedness of the corporation to its general, unsecured creditors, except to the extent subordinated by agreement. General creditors are better off in these situations than they would have been if cash or other property had been paid out for the shares or distributed (which is proper under the statute), and no worse off than if cash had been paid or distributed and then lent back to the corporation, making the shareholders (or former shareholders) creditors. The parity created by section 6.40(f) therefore is logically consistent with the rule established by section 6.40(e) that these transactions should be judged at the time of the issuance of the debt.

## Chapter 7

### SHAREHOLDERS

#### Subchapter A

#### Meetings

##### 7.01 Annual Meeting

(a) A corporation shall hold a meeting of shareholders annually at a time stated in or fixed in accordance with the bylaws.

(b) Annual shareholders' meetings may be held in or out of this state at the place stated in or fixed in accordance with the bylaws. If no place is stated in or fixed in accordance with the bylaws, annual meetings shall be held at the corporation's principal office.

(c) The failure to hold an annual meeting at the time stated in or fixed in accordance with a corporation's bylaws does not affect the validity of any corporate action.

##### 7.02 Special Meeting

(a) A corporation shall hold a special meeting of shareholders:

(1) on call of its board of directors or the person or persons authorized to do so by the articles of incorporation or bylaws;  
or

(2) if the holders of at least 10 percent of all the votes entitled to be cast on any issue proposed to be considered at the proposed special meeting sign, date, and deliver to the corporation's secretary one or more written demands for the meeting describing the purpose or purposes for which it is to be held.

(b) If not otherwise fixed under section 7.03 or 7.07, the record date for determining shareholders entitled to demand a special meeting is the date the first shareholder signs the demand.

(c) Special shareholders' meetings may be held in or out of this state at the place stated in or fixed in accordance with the bylaws. If no place is stated or fixed in accordance with the bylaws, special meetings shall be held at the corporation's principal office.

(d) Only business within the purpose or purposes described in the meeting notice required by section 7.05(c) may be conducted at a special shareholders' meeting.

##### 7.03 Court-Ordered Meeting

(a) The [name or describe] court of the county where a corporation's principal office (or, if none in this state, its registered office) is located may summarily order a meeting to be held:

(1) on application of any shareholder of the corporation entitled to participate in an annual meeting if an annual meeting was not held within the earlier of 6 months after the end of the corporation's fiscal year or 15 months after its last annual meeting; or

(2) on application of a shareholder who signed a demand for a special meeting valid under section 7.02, if:

(i) notice of the special meeting was not given within 30 days after the date the demand was delivered to the corporation's secretary; or (ii) the special meeting was not held in accordance with the notice.

(b) The court may fix the time and place of the meeting, determine the shares entitled to participate in the meeting, specify a record date for determining shareholders entitled to notice of and to vote at the meeting, prescribe the form and content of the meeting notice, fix the quorum required for specific matters to be considered at the meeting (or direct that the votes represented at the meeting constitute a quorum for action on those matters), and enter other orders necessary to accomplish the purpose or purposes of the meeting.

#### 7.04 Action Without Meeting

(a) Action required or permitted by this Act to be taken at a shareholders' meeting may be taken without a meeting if the action is taken by all the shareholders entitled to vote on the action. The action must be evidenced by one or more written consents describing the action taken, signed by all the shareholders entitled to vote on the action, and delivered to the corporation for inclusion in the minutes or filing with the corporate records.

(b) If not otherwise fixed under section 7.03 or 7.07, the record date for determining shareholders entitled to take action without a meeting is the date the first shareholder signs the consent under subsection (a).

(c) A consent signed under this section has the effect of a meeting vote and may be described as such in any document.

(d) If this Act requires that notice of proposed action be given to nonvoting shareholders and the action is to be taken by unanimous consent of the voting shareholders, the corporation must give its nonvoting shareholders written notice of the proposed action at least 10 days before the action is taken. The notice must contain or be accompanied by the same material that, under this Act,