

Recent Delaware and Other Decisions Relevant to the MBCA

WRITTEN BY

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This article describes two recent Delaware decisions relevant to the Model Business Corporation Act (the “MBCA”). One of those decisions relates to a board’s determination of the availability of surplus to support distributions to stockholders, and the other upholds, at the motion to dismiss stage, a claim that the directors breached their fiduciary duty by not taking action in response to a stockholder’s demand. In addition, this article describes recent decisions in MBCA states addressing the meaning of “fair value” and the application of director liability shields to exculpate directors from monetary liability. The MBCA is the basis for the corporation statute of at least 36 states.

DETERMINING SURPLUS TO SUPPORT DISTRIBUTIONS

Corporations often make distributions to stockholders by way of dividends and stock buybacks. For private equity-backed companies, it is not unusual to see leveraged recaps in which the corporation borrows funds to make distributions to the private equity investors. These distributions raise the question for a board of directors of whether the corporation has sufficient funds that are legally available to permit a lawful distribution under the corporate statute. The failure to satisfy the statutory requirement for distributions can result in personal liability for the directors. Determining the funds legally available for distributions can be challenging.

DELAWARE AND MBCA DISTRIBUTION LAWS

Sections 160 and 173 of the Delaware General Corporation Law (the “DGCL”) set the limits on a Delaware corporation’s power to repurchase stock and issue dividends. Section 160 provides that no corporation may purchase or redeem its shares when the capital of the corporation is impaired or would be impaired as a result of such purchase or redemption. A repurchase impairs capital if the funds used for the repurchase exceed the amount of the surplus.^[1] Sections 170 through 173 impose similar requirements for the payment of dividends. Section 170 provides that a board of directors may declare and pay dividends on shares of the corporation’s capital stock either (i) out of its surplus (within the meaning of section 154) or (ii) if there is no surplus, out of the corporation’s net profits for the fiscal year in which the dividend is declared or the preceding fiscal year—so-called “nimble dividends.” The term “surplus” generally means the excess of the corporation’s total assets over the sum of the total liabilities and capital of the corporation (usually the aggregate par value of its outstanding shares). If the test for a lawful distribution or dividend is not met, the directors face personal liability under section 174, which is not subject to exculpation by a charter provision permitted by section 102(b)(7). However, a director is “fully protected” under section 172 from personal liability if he or she relied in good faith upon the corporation’s records or upon its officers, employees, board committees, or experts in determining that the corporation had adequate surplus to support the distribution or dividend.

The MBCA follows a similar approach to the DGCL, although with more statutory precision and some notable differences. Under section 6.40(c), distributions, which include dividends in the MBCA's terminology, may not be made if the corporation would not be able to pay its debts as they become due in the usual course of business (the "equity insolvency test") or its total assets would be less than the sum of its total liabilities and the amount that would be required to satisfy the preferential rights that the holders of senior classes or series of shares would have upon dissolution (the "balance sheet test"). MBCA section 6.40(d) provides that the board of directors may base its determination either on the corporation's financial statements prepared using accounting principles reasonable in the circumstances, which would include those prepared in accordance with generally accepted accounting principles (GAAP), or on a fair valuation or other method reasonable in the circumstances. Under section 7.32, a director approving the improper distribution is personally liable to the corporation for the excess amount if it is established that the director did not meet the standards of conduct in section 8.30, which require that a director act in good faith and in a manner that the director reasonably believes to be in the best interests of the corporation (the so-called duties of care and loyalty). Section 8.30(e) offers protection for directors by providing that a director is entitled to rely on information, opinions, reports, or statements, including financial statements, prepared or presented by officers or employees, lawyers, accountants, or other advisers, or a board committee, so long as the director does not know that reliance is unwarranted.

CHALLENGES TO DISTRIBUTIONS

When a distribution is challenged, it is usually because the board of directors used the present value ^[2] of the corporation's assets to determine surplus rather than the amounts reflected on the corporation's financial statements, which are usually lower. For example, a board might use the current appraised value of real estate even though that real estate is carried on the financial statements at its historic cost less accumulated depreciation. The Delaware Supreme Court has held that a board can use present value in determining surplus as long as it does so in good faith and on a consistent basis.^[3] However, what if the board instead relies on the amounts shown on the corporation's GAAP financial statements?

THE CHEMOURS DECISION

The Delaware Court of Chancery addressed this question and provided important guidance in the case of *In re The Chemours Company Derivative Litigation*.^[4] The Chemours Company ("Chemours") was spun-off by the E.I. DuPont de Nemours Company ("DuPont") in 2015. In the spin-off Chemours assumed certain environmental liabilities of DuPont, which Chemours subsequently claimed to be vastly in excess of the amount that DuPont had stated. This dispute was settled by DuPont's agreeing to share the environmental liabilities. After the spin-off, Chemours made a series of stock repurchases and dividend payments based upon the board's determination that Chemours had adequate surplus based upon the amount of the contingent environmental liabilities reflected on its audited financial statements. The plaintiffs, claiming that demand on the board was excused because it would be futile, brought a derivative action challenging these distributions and dividends as exceeding the available surplus, specifically alleging that the board should have used the amount of the contingent environmental liabilities actually expected rather than relying on the amount shown on the audited balance sheet. To support this allegation, the plaintiffs cited Chemours' own allegations in its dispute with DuPont. Under GAAP, specifically FASB ASC 450-20 (formerly FAS No. 5), only contingent liabilities that are probable and reasonably estimable are accrued and reflected as liabilities on the financial statements.^[5] If a material contingent liability is not probable but is reasonably possible, footnote disclosure is required. Footnote disclosure is also required even if a contingent liability is reasonably possible or probable but is not presently estimable.

The Court addressed whether the plaintiffs had met the burden of proving that demand was futile because a majority of the Chemours directors faced a substantial likelihood of liability. In so doing, the Court addressed the substance of the claims and found that the plaintiffs had failed to plead specific facts implying that the directors faced a substantial likelihood of liability because of the distributions, and therefore the plaintiffs were not entitled to bring the derivative action without first making a demand on the board.

The Court began its analysis of the likelihood of liability by observing that boards of directors have broad authority to determine the amount of a corporation's surplus and, in that connection, the method of determining surplus. Therefore, the Court said that it would defer to the board's calculation of surplus "so long as [the directors] evaluate assets and liabilities in good faith, on the basis of acceptable data, by methods that they reasonably believe reflect present values, and arrive at a determination of the surplus that is not so far off the mark as to constitute actual or constructive fraud"— i.e., that the values "reasonably reflect present values." The Court ruled that the board was not required to depart from GAAP in determining the corporation's reserves for contingent liabilities in the calculation of the corporation's surplus. Accordingly, the Court found that the directors were not "willful or negligent" as required to subject them to liability under section 174. The Court also found that the directors were "fully protected" under section 172 in relying on the corporation's financial statements, consulting with management and financial advisors, and receiving presentations on the environmental liabilities. Finally, the Court found that the plaintiffs' general claim of breach of fiduciary duty, apart from liability for improper distributions, did not result in a substantial likelihood of liability because any such liability was subject to exculpation as permitted by section 102(b)(7), absent bad faith, which the plaintiffs did not plead with particularity.

APPLICABILITY TO MBCA

The Court's approach to distributions and dividends in the *Chemours* opinion is consistent with the approach of the MBCA, as explained in the Official Comment to section 6.40. The *Chemours* opinion gives directors considerable flexibility, and therefore protection from liability, in making determinations of the corporation's surplus to support decisions on dividends and other distributions to stockholders. This allows directors to determine present values, such as the current fair market value of the corporation's assets, and in some cases to use reserves for contingent liabilities reflected in a corporation's GAAP financial statements. The Official Comment to section 6.40 states that "[t]he determination of a corporation's assets and liabilities for purposes of the balance sheet test of section 6.40(c)(2) and the choice of the permissible basis on which to do so are left to the judgment of its board of directors." Similar to Delaware law, the Official Comment to section 6.40 indicates that "[o]rdinarily a corporation should not selectively revalue assets," but "should consider the value of all its material assets," and similarly, "all of a corporation's material obligations should be considered and revalued to the extent appropriate and possible." Section 6.40 authorizes the use of financial statements prepared on the basis of accounting practices and principles that are reasonable under the circumstances and, consistent with the *Chemours* decision, also authorizes any other "method of determining the aggregate amount of assets and liabilities that is reasonable in the circumstances." This means that "a wide variety of methods may be considered reasonable in a particular case even if any such method might not be a 'fair valuation' or 'current value' method."

These determinations under both the DGCL and the MBCA need to be made in good faith, and to demonstrate good faith boards of directors should follow a careful and considered process. That process should be recorded as part of the minutes.

Although reliance on financial statements can protect directors from personal liability for improper distributions, directors dealing with contingent liabilities, whether operating under the DGCL or the MBCA, will want to go beyond the amounts shown in the financial statements. In order to comply with their fiduciary duties, they also should consider the broader information included in any footnote disclosures required under the applicable accounting standards, even if liability for a breach of those duties may be covered by an exculpation provision in the charter.

DETERMINING FAIR VALUE IN APPRAISAL PROCEEDINGS

The primary issue in an appraisal proceeding is the determination of the fair value of the shares held by shareholders exercising their appraisal rights. Section 13.01 of the MBCA defines “fair value” for purposes of appraisal proceedings based on “[t]he value of the corporation’s shares ... using customary and current valuation concepts and techniques generally employed for similar businesses in the context of a transaction requiring appraisal ... and without discounting for lack of marketability or minority status....” This definition gives a court considerable discretion to consider various methodologies including, as applicable, the deal price, unaffected share price analysis, comparable precedent transactions, a comparative company analysis, asset valuations, and a discounted cash flow (DCF) analysis. The method or methods that may be used can vary based upon the circumstances of the particular transaction, and the favored methods have changed over time.

Recently, the Supreme Court of North Carolina in *Reynolds American Inc. v. Third Motion Equities Master Fund Ltd.*^[6] had the opportunity for the first time to interpret the provisions of the North Carolina version of the MBCA to determine if the North Carolina Business Court properly determined the fair value of the shares in an appraisal proceeding of the tobacco company, Reynolds American, which was acquired by British American Tobacco. The Business Court determined that the fair value of the shares did not exceed the deal price of \$59.64 plus interest that had been paid to the dissenting shareholders and therefore no further payments were required.

In upholding the Business Court decision, the North Carolina Supreme Court, in an extensive and detailed analysis, cites freely to the well-developed body of Delaware decisional appraisal law and significantly defers to the exercise of discretion by the Business Court in determining fair value based on the evidence before it. In particular, the Court held that the Business Court’s primary reliance on the deal price was justified, even though the acquisition of Reynolds American by a large, but non-controlling shareholder was not actively marketed. The Business Court used other factors, including indicia of a robust deal process and various other “customary and current valuation concepts and techniques” to confirm that the deal price was indicative of the fair value.

By extensively citing to the well-developed body of Delaware law on determining fair value in an appraisal proceeding, the North Carolina Supreme Court provides support for using the Delaware decisions as relevant precedent for determining fair value under the MBCA, notwithstanding the differences in the appraisal provisions between the two corporate statutes.

A final issue addressed by the Court was the dissenting shareholders’ claim that they were entitled to additional interest under the North Carolina counterpart of MBCA section 13.30(e). Although acknowledging that the provision is “ambiguous,” the Court held that it would be nonsensical and contrary to the legislative intent to award an interest windfall and encourage “appraisal arbitrage” when no additional payment on the shares was due.

DETERMINING FAIR VALUE FOR PURCHASE IN LIEU OF DISSOLUTION

Section 14.34 of the MBCA permits a corporation in a proceeding for judicial dissolution under section 14.30(a)(2) to elect to purchase the petitioning shareholder's shares at their "fair value." If the parties cannot agree on the price and terms of the purchase, the court is required to determine the fair value of the shares and the terms and conditions of the purchase, including whether payments may be made in installments and whether to award any expenses. However, the MBCA does not define "fair value" for purposes of section 14.34 or refer in section 14.34 or in the Official Comment to the definition of "fair value" for appraisal purposes in section 13.01.

In *Bohack v. Benes Service Co.*^[7] the Nebraska Supreme Court addressed the meaning of fair value under the provision of the Nebraska Model Business Corporation Act ("NMBCA") comparable to section 14.34. The Court began by deciding to look to the appraisal provisions of the NMBCA for guidance as to the meaning of fair value in section 14.34. Section 13.01 requires that the fair value of a corporation's shares be determined using "customary and current valuation concepts" and "without discounting for lack of marketability or minority status." Although the Official Comment to section 13.01 states that the "specialized" definitions in section 13.01 apply only to chapter 13, the Court stated that it was not foreclosed from looking to the definition in section 13.01. It noted that the Official Comment was not adopted as part of the NMBCA but went on to observe that in the earlier version of the Official Comment, there was a statement that a court applying section 14.34 might find it useful to consider valuation methods applicable to an appraisal proceeding. That statement is no longer in the Official Comment to section 14.34 in the 2016 Revision of the MBCA. Although the Court noted on this issue and on the discounts issue discussed below that the Nebraska legislature did not adopt the Official Comment, it recognized that the Official Comment is a relevant resource in interpreting the statutory provisions. This reflects the general approach of courts in other states where the Official Comment has not been formally adopted as part of the state's corporation statute. Some states make it a practice to mention in their legislative history that the Official Comment to the MBCA should be considered in interpreting the statute.

The Court next determined that discounts for lack of marketability and minority status should not apply because they are excluded, with certain exceptions not applicable in this case, from the definition of fair value for appraisal purposes. It noted the distinction between "fair value" and "fair market value" in other Nebraska statutes. The Court declined to consider a statement in the Official Comment to an earlier version of the MBCA that a minority discount may be appropriate under section 14.34, a statement that is also no longer in the Official Comment to the 2016 Revision of the MBCA. The Court noted again that the Official Comment was not adopted as part of the NMBCA but went on to state that the Official Comment to the definition of fair value in Section 13.01 states that discounts for lack of marketability or minority status are inappropriate in most appraisal actions because they give the majority an opportunity to take advantage of the minority that is being forced to accept the transaction triggering the appraisal. The Court analogized an appraisal transaction to a forced buyout under section 14.34. However, the Court did not reference other parts of the extensive discussion in the earlier Official Comment identifying the differences between a proceeding under section 14.34 and an appraisal proceeding under chapter 13 that could affect the Court's approach to determining fair value. Those differences include the relevance of liquidation value under section 14.34 when there is deadlock, the need for adjustments when the value of the corporation has been diminished by wrongful conduct of controlling shareholders, and the appropriateness in some circumstances of a minority discount. The earlier Official Comment made it clear that the approach to a valuation is very much dependent on the particular facts and circumstances, that a court in a proceeding under section 14.34 has considerable flexibility, and that using valuation methods relevant to judicial appraisal is

permissible. The reasons for the Court's unwillingness to consider portions of the earlier Official Comment that were not included in the Official Comment to the 2016 Revision are not entirely clear. The elimination or revision of a statement in an earlier Official Comment as part of the editorial process of the Corporate Laws Committee does not necessarily mean that the earlier statement was deemed incorrect or no longer relevant by the Committee. The reasons for editorial changes vary based upon the particular comment omitted or revised. In general, the editing of the Official Comment in the 2016 Revision was designed to streamline it and serve solely as a guide to the interpretation of the applicable statutory provisions and not necessarily because they were no longer considered relevant or correct.

The Court determined that a going concern value was appropriate in the circumstances because the corporation would be continuing in business. It then went into the details of the appropriate valuation methodology, which had unique aspects and which do not need to be recounted here.

DIRECTOR LIABILITY SHIELD

In *Meade v. Christie*^[8], which involved a shareholder's challenge to a going private merger, the Supreme Court of Iowa addressed the relationship of the Iowa counterparts of sections 8.30 and 8.31 of the MBCA and the application of the exculpation provisions authorized by section 2.02(b)(4) of the MBCA (referred to by the Court as the "director shield statute"), and the procedural requirements of those provisions. In its opinion reversing and remanding the trial court's denial of a motion to dismiss by the director defendants, the Court referenced the Official Comment to the 2016 Revision of the MBCA and analyzed the differences between the exculpation provisions of the Iowa Business Corporation Act (the "IBCA"), which are based on those in the MBCA, and DGCL section 102(b)(7).^[9]

The case involved a class action brought by a former shareholder of an Iowa insurance holding company who alleged that the directors breached their "fiduciary duties of care, loyalty, good faith, and candor" by approving the merger in "a flawed process that resulted in too low a price being paid to the minority shareholders." The issue considered by the Court on appeal was whether the shareholder's pleadings were sufficient to show that the IBCA's counterpart of MBCA section 8.31 did not protect the directors from liability. The appeal also involved the issue of whether the claim was a direct or derivative claim but, because of its determination that the directors' motion to dismiss should be granted, the Court did not have to reach the issue of whether the trial court was correct in finding that the claim was properly brought as a direct claim.

The Court began its analysis by discussing the standards of conduct for directors under section 8.30, describing them generally as a duty of care and a duty of loyalty. It then noted that, although section 8.30 provides the standards of conduct, section 8.31 sets forth the conditions for holding a director liable for money damages. Under section 8.31, a director is not liable unless the complainant establishes that an exculpatory provision in the corporation's articles of incorporation authorized by section 2.02(b)(4) does not apply. Since the holding company had adopted an exculpatory provision that tracked the statutory authorization, the Court then analyzed whether the shareholder pled facts sufficient to show that one of the exclusions to exculpation, specifically "intentional infliction of harm on the corporation or the shareholders," applied.

In reaching its conclusion that the shareholder's allegations were insufficient to establish the "intentional infliction of harm" exclusion, the Court looked at the background of exculpation statutes, referring to the MBCA's Official Comment, and compared the MBCA and Delaware exculpation provisions.

Citing the explanation of the Corporate Laws Committee for the addition of a director exculpation provision,^[10] the Court noted that policymakers in the mid-1980s, concerned about qualified individuals declining to serve on boards of directors, began advocating for enhanced protections for corporate directors. These concerns arose out of court rulings that expanded directors' personal liability for money damages, notably the Delaware decision in *Smith v. Van Gorkom*.^[11] After Delaware and other states, including Iowa, amended their corporate statutes to permit director exculpation provisions, the MBCA was amended to further increase the protections for directors. Iowa amended its statute in 2003 to adopt the MBCA exculpation provision. The Court observed that the Delaware exculpation provision in section 102(b)(7), which excludes from exculpation "acts or omissions not in good faith or which involve intentional misconduct," picks up a broader range of fiduciary misconduct than the narrower exclusion of "intentional infliction of harm" standard in the MBCA and the IBCA. Citing the Official Comment to section 2.02(b)(4) stating that the use of "intentional" refers to a specific intent to perform or fail to perform the acts with actual knowledge that it will cause harm, the Court stated that the MBCA standard would not exclude from exculpation claims of reckless conduct, conscious disregard of a duty, or intentional dereliction of a duty, all of which are excluded from exculpation in Delaware. Based on the MBCA's higher bar for an exclusion from liability and the resulting heightened pleading requirement, the Court held that the shareholder's allegations were insufficient to establish an "intentional infliction of harm on the corporation or the shareholders" by the directors. The Court observed that this result was consistent with the purpose of exculpation, to provide not only protection from liability but also to avoid the costs and stress of litigation. It also noted that shareholders who believe a merger buyout price is inadequate have the alternative remedy of appraisal rights under section 13.02.

DIRECTOR DUTIES IN ASSESSING DEMAND

Unlike Delaware, which has a demand required/demand excused approach to derivative actions, the MBCA follows a universal demand approach.^[12] The fundamental premise for the universal demand requirement in the MBCA is that the board of directors should have an opportunity to assess demands and to act in the best interest of the corporation, subject to judicial oversight of its action. Underlying this premise is the requirement that directors fulfill their fiduciary duties in dealing with a demand.

In *Garfield v. Allen*,^[13] the Delaware Court of Chancery considered a challenge by a stockholder of The ODP Corporation to an equity compensation award to the chief executive officer on the ground that it exceeded the limits of the equity compensation plan approved by the stockholders. The Court held that the complaint stated a claim for relief based on a breach of fiduciary duties by the directors in not correcting the violation after the stockholder sent a demand letter to the board calling attention to the issue.

In upholding the claim, the Court noted that it was based on a "novel theory" that the Court accepted with "admitted trepidation" because it could permit plaintiffs in the future to create claims by sending demands to boards if those demands are not acted upon. Nevertheless, although historically a board's rejection of a litigation demand has only affected parties who control the derivative claim and has not been held to be grounds for a separate breach of fiduciary duty claim, the Court found the logic of the claim in this case sound because it indicated a possible conscious failure of the directors to act that could equate to a knowing, wrongful action. The Court, however, urged caution in dealing with this as a basis for such claims going forward.^[14]

This article originally appeared in the Winter 2022 issue of The Model Business Corporation Act Newsletter, the newsletter of the ABA Business Law Section's Corporate Laws Committee. Read the [full issue](#) and previous

issues on the [Corporate Laws Committee webpage](#). Another article by the same author discussing several other recent Delaware decisions relevant to the MBCA appears in the Summer 2021 issue of The Model Business Corporation Act Newsletter. One of those decisions has been reversed by the Delaware Supreme Court, as discussed in an update also appearing in the Winter 2022 issue.

The views expressed in this article are solely those of the author and not Locke Lord LLP or its clients. No legal advice is being given in this article.

[1] See *Klang v. Smith's Food & Drug Centers, Inc.*, 702 A.2d 150, 153 (Del. 1997).

[2] The Delaware courts use the phrase "present value" in this context to mean the current fair market value of the corporation's assets, not the "present value" of the corporation's future cash flows, as used in financial analyses.

[3] See *Klang v. Smith's Food & Drug Centers, Inc.*, 702 A.2d 150, 155 (Del. 1997); see also *Morris v. Standard Gas & Electric*, 63 A.2d 577, 582 (Del. Ch. 1949).

[4] 2021 WL 5050285 (Del. Ch. Nov. 1, 2021).

[5] This is the same standard that applies to lawyer audit response letters.

[6] 379 N.C. 524 (2021).

[7] 310 Neb. 722, 2022 WL 128329 (2022).

[8] 974 N.W.2d 770 (Iowa 2022). See also Matthew G. Doré, *Raincoat or Slicker Suit? An MBCA Director Shield Keeps Board Members Dry in Going Private Suit*, Bus. Law Today (July 13,

2022), <https://businesslawtoday.org/2022/07/raincoat-or-slicker-suit-mbca-director-shield-keeps-board-members-dry-going-private-merger-meade-v-christie/>.

[9] Because the IBCA is based substantially on the MBCA, references herein are to the MBCA sections.

[10] Changes in the Revised Model Business Corporation Act – Amendment Pertaining to the Liability of Directors, 45 Bus. Law. 695, 696 (1990).

[11] 488 A.2d 858 (Del. 1985).

[12] See *Should Demand Ever Be Excused in a Derivative Action? – The Universal Demand Requirement of the MBCA*, MBCA Newsletter, Winter 2021, p. 2.

[13] 2022 WL 1641802 (Del. Ch. May 24, 2022).

[14] The claim in *Garfield* involved the alleged liability of the directors for a breach of their fiduciary duties under Delaware law. As noted in the discussion of the *Meade v. Christie* decision under "Director Liability Shield" above, the standards of conduct for directors under MBCA section 8.30 and the conditions for holding directors liable for monetary damages under MBCA section 8.31 are different.

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