Revaluing Assets and Liabilities When Paying Dividends or Repurchasing Shares

Delaware provides new guidance for boards.

BY DOUG RAYMOND AND TODD SCHLITZ

Boards of directors often seek to return cash to stockholders, in the form of either dividends or stock buybacks. Both methods are common for public companies. In a private equity-backed company, the owners frequently accompany this with a recapitalization within a year or two of acquisition; the existing debt is refinanced and proceeds of the borrowings are distributed to shareholders. While benefitting owners, these transactions can concern lenders and others who may be worried that they can leave the company too highly leveraged or increase the risk that creditors may not be fully repaid.

Boards should give careful consideration to these recapitalizations, buybacks and dividends. In particular, directors should be focused on these transactions because, under the laws of most states, *directors can be personally liable* for dividends or share repurchases that strip out too much equity. For example, unless financed from current or preceding year earnings, the Delaware General Corporation Law (DGCL) prohibits and makes directors personally liable for the payment of dividends and stock repurchases if the amount of the payment exceeds the corporation's "surplus," a term generally defined as the amount of total assets over total liabilities and the par value of the corporation's issued stock (which typically is a nominal amount).

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When determining what surplus exists, boards may, but need not, rely primarily on a balance sheet prepared using generally accepted accounting principles, of the sort required for financial statements filed with the Securities and Exchange Commission or typically provided to the corporation's lenders. While GAAP-compliant balance sheets are a primary resource for surplus calculations, boards also may look to other methodologies that they conclude provide better measures of fair value, including third-party appraisals on assets (and liabilities) that may not appear on a GAAP balance sheet.

In particular, the use of non-GAAP balance sheet methodologies has raised concerns about whether a court would question the board's surplus analysis. A recent Delaware case provides guidance for directors performing this analysis, particularly directors whose companies face contingent future liabilities, such as an environmental exposure or outstanding litigation, or when there may be questions about the value of certain assets, including new technologies.

In *In re Chemours Deriv. Litig.*, the Delaware Court of Chancery addressed two important issues: what deference, if any, would the court apply to the directors' calculation of surplus, and what is the effect of the directors' reliance on experts when calculating surplus. In this case, the board had approved both dividends and stock repurchases at a time when the company also faced legacy contingent environmental liabilities that conceivably could render Chemours insolvent.

The court deferred to the board's determination that there was sufficient surplus to permit these transactions, even though the board looked beyond GAAP-metrics to evaluate its contingent liabilities. The court held that it "will defer to the Board's surplus calculation 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." This standard is consistent with the court's prior guidance that the DGCL "does not require any particular method of calculating surplus, but simply prescribes factors," total assets and total liabilities, "that any such calculation must include."

As for reliance on experts, the court held that, under the DGCL, use of and good-faith reliance on experts "fully protects" directors from personal liability arising from their surplus calculation. In reaching this conclusion, the court rejected the argument that the directors were required to second-guess the GAAP-based reserves calculated by the experts, an analysis that permitted the board to significantly reduce the size of these liabilities on Chemours' balance sheet.

Based on *Chemours*, directors are well advised to compile accurate data regarding total assets and total liabilities, and valuate that data in a reasonable manner, including any analysis provided by experts. The board should together with its experts and other advisors and prepare a complete record of its valuation deliberations, as well as a record of how they chose the experts to advise them. Given the protection a carefully chosen expert can provide, most boards should consider using one if there is any question as to the presence of surplus to cover a proposed transaction. Employing such methods in good faith should result in a court deferring to the board's surplus calculation. ■

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