Potential Pitfalls Of Corporate Distributions

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(i) The year just ended and the shareholders want the corporation to distribute all of its available cash as a dividend.
(ii) The corporation has the opportunity to eliminate a disruptive minority shareholder by redeeming the minority shareholder's stock.
(iii) A leveraged buyout or recapitalization of the corporation is contemplated with the corporation redeeming all of the outstanding shares of a class of its equity securities.

The above scenarios are but three examples of corporate distributions which may run afoul of corporate law restrictions on distributions to shareholders. These restrictions were generally developed when financing techniques were considerably simpler. The complexities of today's financial world have, unfortunately, raced ahead of yesterday's corporate laws. The primary shortcomings involve the lack of clear mandates by which the value of the business enterprise is to be measured in determining the corporate "surplus" which is available for distribution.

Historically, surplus was simply the amount by which the value of assets exceeded total liabilities as reflected on the corporation's balance sheet. Today, however, because of the development of more sophisticated financial analyses, new valuation techniques such as enterprise value have become more accepted in the corporate financial world because of their flexibility and adaptability to different types of transactions. Corporate laws, however, do not expressly permit the use of these new techniques, thus potentially moving distributions outside the traditional safe harbor of surplus. Unless this safe harbor is reached, distributions will generally be unlawful. If the corporation is unable to pay its creditors following an unlawful distribution, directors may be exposed to personal liability and shareholders may be compelled to return distributions. Corporate law restrictions operate in conjunction with state and bankruptcy fraudulent conveyance laws to prevent shareholders from benefiting at the expense of creditors. These issues are relevant to every corporation, big or small, public or private.

1. Types Of Distributions

When most business people think of distributions, they typically think of cash dividends. However, corporate law restrictions generally extend to *any* transfer of cash or property to shareholders. These transfers may be effectuated, for example, through a dividend, the incurrence of a debt by the corporation for the benefit of shareholders or the redemption or repurchase by the corporation of any of its equity securities. Irrespective of the label, if shareholders are enriched at the expense of the corporation and as a result existing creditors cannot be paid in full, an unlawful distribution may have occurred.

2. Restrictions On Distributions

The specific statutory provisions of corporate laws which govern distributions vary from state to state.[1] However, corporate statutes generally prohibit corporations from distributing corporate assets (*i.e.*, cash or property) to shareholders if after doing so (i) the value of the remaining assets of the corporation would be less than the total of the corporation's liabilities (the Balance Sheet Test) or (ii) the corporation would be unable to pay its debts as they become due in the ordinary course of business (the Equity Test).[2] State and bankruptcy fraudulent conveyance laws[3] contain similar restrictions which apply in the event that a corporation makes a transfer of assets without receiving reasonably equivalent value in exchange.

3. The Balance Sheet Test And Valuation Techniques

The tests contained in state corporate laws (the Balance Sheet and Equity Tests) are unambiguous; distributions may only be made out of "surplus"[4] provided that after the distribution the corporation will still have sufficient assets to pay its debts in the ordinary course of business. However, ambiguity exists as to the appropriate method for valuing or measuring the assets and liabilities when preparing the balance sheet. Some corporate laws, including New Jersey's (*N.J.S.A.* 14A:7-14.1(2)), provide different alternatives for its preparation. These methods include the use of a balance sheet prepared on the basis of (i) generally accepted accounting principles (GAAP), (ii) fair market valuations and (iii) other reasonable accounting practices. However, no guidance is provided to determine whether assets and liabilities may be valued in the aggregate by using a going-concern or enterprise value or whether assets should be valued only on an individual stand-alone basis. If the latter, is the value that which each asset could be sold in the ordinary course of business, or at fire-sale or liquidation value? Lastly, should liabilities (both existing and contingent) be valued at their fair value? These issues have not been generally considered by courts outside of the bankruptcy context.[5] In fact until May 1997, none of the state courts in Delaware, New Jersey or New York had expressly addressed the use of enterprise value.[6]

The most conservative approach in preparing the balance sheet is to value each asset separately at liquidation value. This nuts and bolts approach will likely significantly undervalue the assets of the corporation, but if such valuation standard allows the corporation to satisfy the Balance Sheet Test, a reasonable margin for error is likely to exist. The middle ground is to value the assets at net book value in accordance with GAAP or to value each asset at fair market value if the book value, because of depreciation, does not fairly reflect the true fair market value of the assets. The most aggressive valuation technique is to value the corporation on a going-concern or enterprise basis. Enterprise value is generally representative of the value which a willing third-party would pay for the corporation as a going-concern with all of its assets in-place. Enterprise valuations are typically performed by investment bankers, corporate appraisers or other qualified financial advisors and are the basis upon which the financial community currently chooses to do business, particularly in the LBO context.[7]

4. Liability For Unlawful Distributions

In the event that an unlawful distribution is approved or concurred in by directors (*i.e.*, no dissent) and the corporation is thereafter unable to pay its creditors, each approving or concurring director will be an attractive target for creditors and may have personal liability for the full amount of the distribution. Shareholders who have received the distribution may also be forced to return the distribution to the corporation.

Regardless of the valuation technique actually used, all valuations should be set forth in writing and should be conservative and thorough. Valuation reports should be attached as exhibits to the minutes of the board of directors' meeting at which the distribution is approved. It is important to remember that in the event that the distribution is challenged because creditors have not been paid in full, the court will review the lawfulness of the distribution with the benefit of hindsight. Thus, the better the documentation of the calculations at the time of the distribution, the more likely that the distribution will be upheld and the directors afforded the statutory safe harbor of reliance on experts.

5. The Equity Test

With respect to the Equity Test, it is important to prepare the corporation's cash-flow projections giving effect to the completed distribution. If possible, obtain a solvency opinion from an independent investment bank or other financial advisor. These reports must indicate that following the distribution, the corporation will be able to pay its debts in the ordinary course of business. As with the preparation of the balance sheet, the cash-flow projections should be conservative and complete, should include all reasonably foreseeable expenses and should allow for reasonably foreseeable changes to the assumptions relied on in the projections (*e.g.*, higher costs) post transaction.

6. Director Standard Of Care

Notwithstanding that some uncertainty exists regarding appropriate techniques for satisfying the Balance Sheet and Equity Tests, corporate laws are generally clear that directors can avoid personal liability if they satisfy the statutory standard of care when approving a distribution.[8] Such care generally involves the carrying out of duties in good faith and with that degree of care, diligence and skill which an ordinarily prudent person would exercise under similar circumstances. Moreover, a director may rely on reports furnished by officers of the corporation, and on reports or opinions prepared by accountants, attorneys and other professionals retained by the corporation. If directors undertake the requisite review and reasonably rely on the reports and opinions, and the distribution is subsequently held to be unlawful, the director may be able to avoid personal liability. However, as stated above, courts will review the valuations and projections relied on by directors with the benefit of hindsight usually *after* the corporation has failed, leaving a trail of hostile creditors and a higher hurdle in establishing the reasonableness and good faith of the directors' reliance on the expert's reports.

7. Attorney Opinion Letters

Attorneys are sometimes requested to deliver legal opinions to the board of directors and/or to third parties (*e.g.*, lenders or distributees) that a distribution satisfies all applicable laws. Attorneys should not give this opinion in a vacuum as it requires knowledge and information often outside of an attorney's expertise. Generally, attorneys should not give any opinion as to the correctness or completeness of these financial reports but should assume, with the consent of the opinion recipient, such correctness/completeness.

The number of matters in which claims are made by unpaid creditors following distributions is small, but the consequences of being wrong are often great. Since the valuations supporting a distribution are always reviewed on a case-by-case basis with the benefit of hindsight, and directors face potential personal liability and shareholders face the prospect of having to return unlawful distributions, the decision to make any distribution should only be made following the most careful analysis and cautious assessment by the board of directors and its advisors.

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[1] *A review of the corporate laws of each of the fifty states is not feasible in this article. Thus, the references to state corporate laws in this article will be limited to Delaware, New Jersey and New York.* See *8 Del. C. §§ 160 and 170;* N.J.S.A. *14A:7-14.1; and N.Y. Bus. Corp. §§ 510 and 513 (McKinney 1997).*

[2] *Note that under Delaware law, 8 Del. C. § 170, a corporation is permitted to pay cash dividends out of its net profit even in the event that no surplus exists.*

[3] See *11* U.S.C. *§ 548; 8 Del. C. § 1301;* N.J.S.A. *25:2-20; and N.Y. Debt. & Cred. § 270 (McKinney 1997).*

[4] *Surplus is generally understood to be the amount by which the value of the corporation's assets exceeds its total liabilities. Under some state corporate laws, the aggregate par value of issued stock is also subtracted from the net value of the corporation's assets in calculating surplus.* See *8 Del. C. § 154.*

[5] *The Bankruptcy Courts apply federal law and are in disagreement as to the appropriate valuation technique.* See e.g. In re F.H.L., Inc., *91 Bankr. 288 (D. N.J. 1988);* Moody v. Security Pacific Credit, Inc., *127 Bankr 958 (W.D. Pa. 1991),* aff'd, *971 F.2d 1056 (3d Cir. 1992);* In re Trans World Airlines, Inc., *180 Bankr. 389 (D. Del. 1994),* aff'd in part and rev'd in part, *1996 WL 751077 (D. Del. 1996).*

[6] *In May 1997, the Delaware Court of Chancery in* Klang v. Smith's Food & Drug Centers, Inc., *1997 Del. Ch. Lexis 73, 1997 WL 257463, expressly held that going-concern value was an appropriate valuation technique to be used in determining whether a distribution satisfied the Delaware corporate law restrictions. Delaware has the most developed body of corporate case law and its courts are probably most likely to uphold the lawfulness of a distribution where enterprise value is the method of valuation relied on to support the distribution.*

[7] *Enterprise values may be arrived at through different techniques. One traditional technique is to multiply the earnings of the corporation by the multiple which is appropriate for the industry in which the corporation is involved.*

[8] See *8 Del. C. §§ 141 and 172;* N.J.S.A. *14A:6-14; N.Y. Bus. Corp. § 717 (McKinney 1997).*

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