Dividend Recapitalizations: An Outline of Risks and Best Practices

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1. Dividend Recapitalizations.

1.1. What is a dividend recapitalization? A dividend recapitalization (or "dividend recap" for short) is a transaction where a company borrows money to issue a special dividend to owners or stockholders. Dividend recaps have become a popular tool that private equity firms use to return capital to their investors.

2. Constructive fraudulent transfers.

2.1. A dividend may constitute an avoidable fraudulent transfer under section 548 of the Bankruptcy Code. Section 548(a)(1)(B) of the Bankruptcy Code provides:

> The trustee may avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . .
>
> (B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

2.1.1. Did the company receive reasonably equivalent value in exchange for such transfer or obligation?

2.1.2.1. In a dividend recap, it will be difficult to argue that the company has received value in exchange for the dividend.

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2.1.2. If there is no reasonably equivalent value, to avoid transfer the trustee must also show that one of three standards applies:

2.1.2.1. Balance Sheet Insolvency. The company was insolvent on the date the transfer was made or the obligation was incurred, or became insolvent as a result of such transfer or obligation. The Code defines insolvent to mean "financial condition such that the sum of such entity's debts is greater than all of such entity's properties at a fair valuation, exclusive of property transferred, concealed or removed with intent to hinder, delay or defraud such entity's creditors." 11 U.S.C. § 101(32).

2.1.2.2. Insufficient Capital. The company was engaged in a business or a transaction, or was about to engage in a business or transaction, for which any property remaining with the debtor was an unreasonably small capital - the sufficiency of capital test.

2.1.2.3. Inadequate Cash Flow. The company intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

2.1.3. BAPCPA expanded the statute of limitations to cover transfers within two years before the date of the filing of the petition (previously one year).

2.2. A dividend may be avoidable under the state law provisions of the Uniform Fraudulent Transfer Act. These provisions are also available to a bankruptcy trustee.

2.2.1. Two-pronged definition of insolvency.

2.2.1.1. A debtor is insolvent if the sum of the debtor's debts is greater than all the debtor's assets, at a fair valuation, or

2.2.1.2. A debtor who is generally not paying his debts as they become due is presumed to be insolvent.

2.2.2. Massachusetts General Laws Chapter 109A, § 5 fraudulent transfer test - Insufficiency of capital or insufficient cash flow.

2.2.2.1. Lack of reasonably equivalent value in exchange for the transfer or obligation, and

2.2.2.2. Either the debtor was engaged or was about to engage in a business, or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or intended to incur or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due.

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2.2.3. Chapter 109A, § 6 - Balance sheet insolvency and payments to insiders.

2.2.3.1. The debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation, or

2.2.3.2. Transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

2.2.4. There is a 4 year statute of limitations under UFTA, except for transactions that are avoidable only as payments of antecedent debts to insiders, which are subject to only a one-year statute.

3. Limitations on Dividends/Distributions.

3.1. Delaware General Corporation Law (§§ 154, 170).

3.1.1. The Directors may declare and pay a dividend either out of surplus or net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year.

3.1.2. Surplus is the excess of fair market value of net assets (*i.e.* excess of total assets over total liabilities) over capital.

3.1.3. There are mechanisms under Delaware law (e.g. § 244) that can be used to decrease capital and thereby increase surplus in order to enable a dividend. However, no reduction of capital "shall be made or effected unless the assets of the corporation remaining after such reduction shall be sufficient to pay any debts of the corporation for which payment has not been otherwise provided."

3.1.4. Board members may rely in good faith upon the records of the corporation and upon information, opinions, reports or statements presented to the corporation by officers, employees, Board committees, or advisors reasonably believed to have professional or expert competence and who have been selected with reasonable care, as to asset values, liabilities, net profits or other relevant facts relating to surplus.

3.1.5. Statutory liability for unlawful dividends is joint and several among directors and runs for six years after payment.

3.1.6. Stockholders with knowledge of facts indicating that a dividend was declared unlawfully are liable to the corporation for the amount they received.

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3.2. The Delaware Limited Liability Company Act (§ 18-607).

3.2.1. An LLC cannot make a distribution to a member to the extent that at the time of the distribution, after giving effect to the distribution, the liabilities of the LLC exceed the fair value of the assets of the LLC.

3.2.2. "Liabilities of an LLC" do not include liabilities to members on account of their limited liability interests or liabilities for which the recourse of creditors is limited to specified property of the LLC.

3.2.3. The term "distribution" does not include amounts constituting reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to bona fide retirement plan or other benefit plan.

3.2.4. Managers have the same reliance defenses as corporate board members under § 18-406.

3.2.5. A member who receives a distribution in violation of the test, and who knew at the time of the distribution that it violated the test, is liable to the LLC for the amount of the distribution.

3.2.6. A member who receives a distribution in violation of test, and who did not know at the time of the distribution that the distribution violated the test, is not liable for the amount of the distribution.

4. Solvency opinion.

4.1. A financial advisor's opinion that the corporation will not become insolvent as a result of a proposed transaction.

4.2. Financial and valuation analyses address three tests that represent legal and economic standards of measuring solvency. All three tests must be passed for opinion of solvency:

4.2.1. Balance sheet test – liabilities vs. fair value of assets.

a. value assets at highest and best use;
b. use appropriate premise of value (generally "going concern");
c. liabilities valued at face value, plus proposed financing, plus contingent liabilities; and
d. to value operating assets as part of a going concern generally requires consideration of income approach methods (discounted cash flow or capitalization of earnings), market approach methods, and asset approach methods.

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4.2.2. Cash flow test – ability to pay debts as they mature.

a. compare future debt payments (post-transaction) vs. corporation's ability to meet obligations through internal cash flow and credit availability; and
b. consider risk associated with increased leverage and relative ease/difficulty associated with meeting obligations.

4.2.3. Adequate capital test – is post-transaction capital reasonable?

a. Does debtor have adequate capital post-transaction to meet short term
   i) Operating expenses
   ii) Capital expenses
   iii) Debt service

b. Analyze corporation under various scenarios, such as
   i) Management projections
   ii) Zero growth projections

c. Company must be able to fund its ongoing business operations

d. Working capital remaining should be able to cover a short term business downturn.

4.3. Benefits of a contemporaneous, independent financial advisor solvency opinion.

4.3.1. Reduces risk of litigation and likelihood of penalties.

4.3.2. Provide evidence that proper procedures were followed and fiduciary obligations were met.

4.3.3. Results of analysis allows stakeholders to assess transaction risks.

4.3.4. Not a guarantee.

4.3.5. Effect is maximized if analyses are consistently performed in the same fashion.

5. **Solvency Analysis: Common Errors and Considerations**

5.1. What is the "enterprise value," how is it calculated, and what are appropriate "multiples" to use with this measure?

5.1.1 Must always check the definitions used in any analysis, but generally the "enterprise value" is the same as "aggregate market value," "total invested

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capital," or "market value of invested capital." In general, this refers to the value of the equity plus the value of the debt (more detail below…).

5.1.2 Enterprise value = [Stock price * diluted shares] plus [market value of long term debt plus short term debt, including capital lease obligations and excluding seasonal borrowings] plus [market value of preferred stock] plus [minority interests] less [cash and cash equivalents, not including restricted cash].

5.1.3 Multiples using "enterprise value" in the numerator may have earnings measures such as EBITDA or EBIT in the denominator. However, it is not proper to measure "EBITDA per share," price/revenues per share, price/EBIT per share, etc.

5.2. Enterprise value does not equal asset value…

5.2.1. The "balance sheet test" compares the assets (as adjusted) vs. the liabilities. Note that assets = [liabilities + equity] = [current liabilities + short term debt + long term debt + equity].

5.2.2. Valuation methodologies such as a discounted cash flow generally calculate the value of the "enterprise" (an "enterprise valuation", see above). As noted above, the "enterprise value" measures the value of the equity plus the debt (short term and long term).

5.2.3. However, in order for this to be equivalent to the value of the assets (see 5.2.1), we must add the value of the "current liabilities" to the "enterprise value".

5.3. Should cash be deducted from "enterprise value"?

5.3.1. Some argue that only cash should not be deducted, since a certain amount of "operating cash" is needed to continue operations. However, it is difficult to distinguish between operating cash and "excess cash" for each comparable company. Further, if a large debt financing example is considered, we see that comparability is best achieved by deducting cash.

5.3.2. Assume: Market capitalization (equity value) = $100, Debt = $75, Cash = $50. If cash is deducted then the enterprise value = $125 [Scenario A]. If cash is not deducted, then the enterprise value = $175 [Scenario B].

5.3.3. If $25 cash is used to repay debt, then the enterprise value in Scenario A remains $125 [100 + 50 – 25]. However, the enterprise value in Scenario B would change from $175 to $150 [100 + 50].

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5.3.4. Further, if the Company borrows $50 in A, the enterprise value would remain $125 [100 + 125 – 100]. However, the value in B rises to $225 [100 + 125].

5.3.5. Not logical that a company reduces its value simply by paying off debt, or that it increases its value simply by borrowing.

5.4 Use of “average” multiples without considering complete set of selected multiples.

i) Arithmetic average – when used with multiples, this incorrectly weights the samples with an upward bias.

ii) Median – this is useful if the sample is large, but this only identifies a mid-point and information from each sample is lost.

iii) Quartiles – provides insight into dispersion of sample

iv) Harmonic mean – take the reciprocal of each multiple, calculate the arithmetic mean of these reciprocals, take the reciprocal of this result. See attached example.

5.5 Sensitivity of DCF to changes in discount rate.

i) Final year of forecast

ii) Terminal year

iii) Gordon growth vs. Terminal exit multiple

iv) “Cross checking” methods above

v) Consider CAPM or build up method vs. return required by equity investors

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