



# Dividends, Redemptions and Stock Purchases

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This Note covers the actions necessary for a Delaware corporation to effect a dividend, redemption or stock purchase (also known as a stock buyback or stock repurchase). It explains the applicable laws, the resources the corporation may use and the standard of review that Delaware courts apply when reviewing a dividend, redemption or stock purchase transaction.

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Corporations typically use dividends, redemptions and stock purchases to distribute cash, stock or other assets as a return on the investment of their stockholders. For corporations incorporated in Delaware, the actions necessary to effect a dividend, redemption or stock purchase (also known as a stock buyback or stock repurchase) and the legal limitations on the ability to do so, are governed by the Delaware General Corporation Law (DGCL) and Delaware case law.

This Note focuses on Delaware law and does not cover the securities law issues that may be applicable in stock repurchases of a public company. This Note also does not address the disclosure rules that may be associated with repurchases of stock. For more information on public stock repurchases, see *Practice Note, Issuer Stock Repurchases: What are the Options?* (<http://us.practicallaw.com/5-503-3856>).

This Note provides an overview of the Delaware law governing dividends, redemptions and stock purchases, including:

- The actions necessary for a Delaware corporation to effect a dividend, redemption or stock purchase.
- The resources a Delaware corporation can use to effect a dividend, redemption or stock purchase.
- The standard the Delaware courts will use to review the transaction.
- The potential personal liability to directors and how to protect against that liability.

## NECESSARY CORPORATE ACTIONS TO EFFECT A DIVIDEND, REDEMPTION OR STOCK PURCHASE

### How to Issue Dividends

Generally speaking, a dividend is a pro rata payment to the stockholders of a corporation as a return on their investment. It may be made in the form of cash, stock or other property. A corporation may effect a dividend to achieve a variety of goals. For example:

- Paying a cash dividend to provide a return of capital to stockholders.
- Paying a stock dividend to obtain a result similar to a stock split (see *Stock Split Checklist* (<http://us.practicallaw.com/3-504-2220>)).
- A corporation spinning off a subsidiary by declaring and paying a dividend for the subsidiary's stock (a dividend of the parent corporation's property) to its stockholders (see *Practice Note, Spin-offs: Overview* (<http://us.practicallaw.com/2-503-1986>)).
- Implementing a poison pill by paying a dividend of a right to acquire a corporation's stock on the terms specified in its rights plan (see *Practice Note, Poison Pills: Defending Against Takeovers and Protecting NOLs* (<http://us.practicallaw.com/3-386-0340>)).

### Authority and Governing Documents

Section 170 of the DGCL vests the power to declare dividends exclusively in a corporation's board of directors. However, a corporation's certificate of incorporation (including any certificates of designation of preferred stock) may limit a board's authority to declare dividends.

For example, a certificate of designation of a series of preferred stock may either:

- Prohibit the board from declaring a dividend on common stock while that series of preferred stock is outstanding.
- Require the consent of the holders of a majority of that series of preferred stock to approve a dividend.

Therefore, counsel should review that corporation's certificate of incorporation (including any certificates of designation of preferred stock) to determine if there are any limitations on the board's authority to declare dividends.

Counsel should also review a corporation's certificate of incorporation and by-laws for any prescriptive provisions relating to the method of board action. Section 141 of the DGCL provides default rules that a board of directors may act to declare a dividend by either:

- The vote of the majority of the directors present at a meeting at which a quorum is present.
- The unanimous written consent of directors.

However, these default rules may be altered by a corporation's certificate of incorporation or by-laws. If the board takes action at a meeting, the by-laws may also set out provisions such as the notice required to be provided to directors for that meeting.

The authority to declare a dividend may be delegated to a committee or subcommittee of directors. For corporations incorporated before July 1, 1996 that have not elected to be governed by Section 141(c)(2) of the DGCL, this delegation must be explicitly stated. For all other Delaware corporations, a committee's power to declare a dividend may be implicitly given by a general grant of authority.

### Steps to Declare a Dividend

In declaring a dividend, a board of directors (or committee or subcommittee of the board) generally:

- Fix a record date for determining the stockholders entitled to receive payment of the dividend.
- Determine the payment date for the dividend.

Under Section 213(c) of the DGCL the record date for determining the stockholders entitled to receive payment of the dividend:

- Cannot precede the date that the board acts to fix the record date.
- Must be within 60 days of the date of payment of the dividend.

However, if the board does not fix a record date for determining the stockholders entitled to receive payment of the dividend, the statutory default record date is the close of business on the date of declaration of the dividend.

Although outside the scope of this Note, stock exchange rules put in place to regulate when a stock begins to trade on an ex-dividend basis may affect the timing of the declaration and payment of a dividend by public corporations. Typically a public security purchase does not settle until the third trading day after the purchase and, therefore, even if a security is bought before the record date, the buyer does not become the holder of that security on the record date and become entitled to a dividend unless the trade settles by the record date.

To address this issue, stock exchanges have issued additional notice requirements. For example, Section 204.12 of the New York Stock Exchange Listed Company Manual requires notice of a dividend to be given to the NYSE at least ten days in advance of the record date.

Generally, once an unconditional dividend is declared, a debtor-creditor relationship is created between the corporation declaring the dividend and its stockholders. This means that stockholders entitled to the dividend might have a cause of action if the corporation can legally pay the dividend, but fails to pay it when due. For this reason, a board may consider expressly stating that the dividend is conditioned on, among other things, the board not revoking the dividend before the payment date.

### Important Considerations for Stock Dividends

Two specific issues should also be considered if a stock dividend is being declared.

If the stock dividend is one of previously unissued shares of the corporation, Section 173 of the DGCL generally requires that the board designate an amount which is not less than the aggregate par value of par value shares being declared as a dividend as part of the corporation's capital. If the shares being declared are without par value, then the amount to be designated is determined by the board of directors (for further discussion of the capital requirements, see *Resources a Corporation May Use to Effect a Dividend, Purchase or Redemption*).

If the denominator used in the dividend ratio is anything other than one (for example, if the stock dividend is three shares of stock for every two owned), Section 155 of the DGCL permits the corporation not to issue fractional shares. If the corporation decides not to issue fractional shares, it must take one of three actions:

- Arrange for the disposition of fractional interests. For example:
  - by aggregating them; or
  - by selling them in the market and distributing the resulting consideration to stockholders otherwise entitled to those interests.
- Pay the fair value of fractions of a share in cash. The fair value is determined as of the time it is determined who is entitled to receive the fractional shares.
- Issue scrip or warrants entitling the holder to receive a full share when it surrenders the scrip or warrants once they aggregate to a full share.

### How to Effect Redemptions and Stock Purchases

A stock purchase is a voluntary acquisition by a corporation of its stock from a stockholder under no legal obligation to sell its stock back to the corporation. In contrast, a redemption is limited under Section 160(a)(3) of the DGCL to an acquisition compelled by the provisions of a corporation's certificate of incorporation (including a certificate of designation). A redemption can be the result of either a:

- Put right (meaning, a right of a stockholder to cause the corporation to purchase its shares).
- Call right (meaning, a right of the corporation to cause the stockholder to sell its shares to the corporation).

Both a stock purchase and a redemption can be conditioned on the happening of a specific event. The DGCL does not restrict the type of consideration that can be paid for the purchase or redemption of stock.

#### Authority and Governing Documents

Unlike the declaration of a dividend, which Section 170 of the DGCL reserves exclusively to a corporation's board of directors, stock purchases and redemptions do not necessarily require board action (*DGCL § 160*). However, in practice, the board typically approves redemptions and stock purchases. This is a function of both:

- A corporation is managed under the direction of its board under the general principle of the DGCL.
- The liability that may be imposed on directors for stock purchases or redemptions resulting from willful or negligent violation of the DGCL (see *Potential Personal Liability to Directors and How to Protect Against that Liability*).

A corporation's certificate of incorporation may place limitations on the authority of the corporation to effect a stock purchase or a redemption. Therefore (as with a dividend), counsel should review the corporation's certificate of incorporation (including any certificates of designation of preferred stock) to determine if it contains any limitations. Counsel should also review the corporation's certificate of incorporation and by-laws for any provisions relating to the method of taking corporate action.

#### Important Considerations for Redemptions and Stock Purchases

The following issues must also be considered before effecting a redemption or stock purchase:

- Subject to limited exceptions, a redemption may not be effected (even if drafted as mandatory in a corporation's certificate of incorporation) if there would be no outstanding voting shares of the corporation following the redemption (*DGCL § 151(b)*).
- Shares that are then subject to a redemption provision giving the corporation a call option may not be purchased for more than the price at which they then may be redeemed (*DGCL § 160(a)(2)*).
- Stock that has been called for redemption can no longer vote and cannot be counted for quorum purposes when notice of the redemption has been given and the acquisition price has been irrevocably deposited or set aside for payment (*DGCL § 160(d)*).

## RESOURCES A CORPORATION MAY USE TO EFFECT A DIVIDEND, PURCHASE OR REDEMPTION

### The Surplus Requirement

Other than a narrow exception, Sections 170 and 173 of the DGCL prohibit a Delaware corporation from declaring or paying a dividend except out of "surplus." Similarly, Section 160 of the DGCL (subject to a narrow exception) prohibits a Delaware

corporation from purchasing or redeeming its own shares if the corporation's capital is "impaired" or the purchase or redemption would impair the capital of the corporation.

This prohibition against capital impairment has been interpreted to mean that a corporation may use only its surplus for purposes of making distributions in connection with a stock purchase or redemption. Therefore, the ability of a corporation to effect a dividend, stock purchase or redemption is limited by the amount of that corporation's surplus.

"Surplus" is defined in Section 154 of the DGCL as, "[t]he excess, if any, at any given time, of the net assets of the corporation over the amount...determined to be capital."

"Net assets" is defined by Section 154 of the DGCL to mean "the amount by which total assets exceed total liabilities." This definition of net assets is essentially a balance sheet test.

Therefore, as a practical matter, the surplus requirement prohibits "distributions to stockholders that would render the company balance-sheet insolvent, but instead of using insolvency as the cut-off, the line is drawn at the amount of the corporation's capital" (*SV Inv. Partners, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973, 982 (Del. Ch. 2010)). However, the value of a corporation's assets should generally be measured at actual current value even if the "book value" reflected on the formal balance sheet is different (see *Valuing a Delaware Corporation's Assets and Liabilities for Purposes of the Surplus Test*).

Section 154 defines "capital" for purposes of the surplus test. Unless the board of a corporation has provided otherwise, the capital of a Delaware corporation for purposes of the surplus test is equal to the aggregate par value of all of its previously issued (meaning, outstanding and treasury) shares. If no-par-value shares have been issued, the default rule is that the amount of consideration received for each share is included in a corporation's capital. Because many corporations issue stock with par value of \$0.01 or less, the surplus test is nearly equivalent to a balance sheet insolvency test.

There is some ambiguity on when the surplus test must be satisfied when issuing dividends. Based on a literal reading of Section 170, which states that the directors "may declare and pay dividends...out of [the corporation's] surplus," there is an argument that a corporation would have to satisfy the surplus test at the time of the declaration of the dividend as well as at the time of payment of the dividend. As one treatise on Delaware Corporation Law observes, common sense suggests that the payment date is the operable benchmark (see *David A. Drexler, Lewis S. Black, Jr., and A. Gilchrist Sparks, III, Delaware Corporation Law and Practice*, s. 20.02 n.15).

### Valuing a Delaware Corporation's Assets and Liabilities for Purposes of the Surplus Test

The DGCL does not specifically address how a corporation's assets and liabilities should be valued for purposes of a board's determination of surplus. Relevant case law, however, has established that the value or amount of the assets of a Delaware corporation should be determined whenever it is necessary to ascertain the existence or amount of surplus. In other words, a board of directors should determine the existence of surplus in light of current value of its assets, which may differ from book value.

However, directors do not need a formal appraisal to determine surplus. Rather, as the Delaware Court of Chancery observed in *Klang v. Smith's Food & Drug Centers, Inc.*:

"[T]his Court has already rejected the claim that asset valuations for the purpose of determining available surplus may not include elements reflective of a going-concern value. Directors are not restricted in the way they value assets or liabilities as long as they fulfill their 'duty to evaluate the assets on the basis of acceptable data and by standards which they are entitled to believe reasonably reflect present values.' Thus, the issue here is not whether Houlihan's [the valuation firm hired to serve as an expert] method is expressly permitted under section 160, but whether [the] directors based their revaluation on acceptable data and whether they were entitled to believe that Houlihan's valuation of [the corporation's] asset values reasonably reflected [the corporation's] asset values both before and after the repurchase."

(1997 WL 257463, at \*4 (Del. Ch. May 13, 1997), affirmed by 702 A.2d 150 (Del. 1997).)

Although many of the cases discussing the duty of directors to value assets at current value also generally refer to valuing liabilities in a similar manner, this is still an area of unsettled law in Delaware.

In *Angelo, Gordon & Co., L.P. v. Allied Riser Communications Corporation*, the Court of Chancery considered whether a corporation was balance-sheet insolvent (805 A.2d 221 (Del. Ch. 2002)). The defendants' financial expert stated that the value of the corporation's outstanding notes should be discounted to reflect the discounted prices they were trading at. The Court of Chancery observed that while "it is appropriate to fair value assets," "it cannot ordinarily be true that one should mark debt to market unless the Company has a right to reacquire that debt at that price" (see *Angelo, Gordon*, at 224 n.10).

The use of the phrase "cannot ordinarily be true" suggests that this is not a rigid rule and the Court of Chancery pointed to long-term debt carrying a favorable coupon as an example of where reducing debt to present value may be appropriate. Therefore, the appropriateness of discounting debt to market value requires further development in the courts. As a matter of best practice, corporations should generally avoid "marking their debt to market."

Difficult questions also arise in determining the present value of contingent liabilities. At least one Delaware case addressed

the present value of contingent liabilities in the context of a corporation's dissolution (*Boesky v. CX Partners, L.P.*, 1988 WL 42250 (Del. Ch. 1988)). Here, the Court of Chancery suggested that, in the absence of "a sufficiently large number of similar claims so that statistical techniques might apply," the safer approach is not to "discount the claim by a probability of success" (*Boesky*, at \*16). The Delaware courts have not provided direct guidance on valuing contingent liabilities in the context of a going-concern corporation paying a dividend.

If a corporation has material contingent liabilities and is considering effecting a dividend, stock purchase or redemption, its board may wish to seek further advice from counsel and financial advisors to assist in valuing those liabilities.

Another area that has not yet been tested by the Delaware courts is the surplus calculation in a corporation with material subsidiaries. If a corporation has subsidiaries, the assets of that corporation include the equity that it holds in the subsidiaries. Presumably the value of that stock is influenced by the value of any assets held by the subsidiary, as well as any liabilities at the subsidiary level.

### Other Potential Limitations on Resources a Corporation May Use to Effect a Dividend, Stock Purchase or Redemption

#### Fraudulent Transfer

Even if a corporation has surplus, its ability to effect a dividend, stock purchase or redemption may be limited by other applicable law. In particular, counsel and the board should be aware of the laws against fraudulent transfers.

Although the surplus rule applies to all Delaware corporations as a matter of Delaware law, counsel should refer to the applicable conflict of law rules to determine which jurisdiction's laws regarding fraudulent transfers applies to a given distribution. Most states have adopted a form of the Uniform Fraudulent Transfer Act.

Delaware's version of the Uniform Fraudulent Transfer Act is located in Title 6, Chapter 13 of the Delaware Code. Under Delaware's version, a transfer (such as in a dividend, stock purchase or redemption) is fraudulent regarding a creditor if these conditions are met:

- The transfer must have been made with actual intent to hinder, delay or defraud the creditor or without the corporation receiving a reasonably equivalent value in exchange.
- The corporation must either:
  - be engaged in a business for which its remaining assets were unreasonably small in relation to the business; or
  - have intended to incur or have believed or reasonably should have believed that it would incur debts beyond its ability to pay as they became due.

To avoid the remedies granted to creditors under the fraudulent transfer act, a board considering a dividend, stock purchase or redemption should (in addition to meeting the surplus



requirements under Delaware law) determine whether, following the dividend, stock purchase or redemption, the corporation will either:

- Have an unreasonably small amount of capital for the business in which it is engaged or intends to engage in.
- Not be able to pay its debts as they become due.

For more information on fraudulent conveyance laws, see *Practice Note, Fraudulent Conveyances: Issues and Strategies for Lenders and Private Equity Sponsors* (<http://us.practicallaw.com/8-382-2478>).

#### Funds Legally Available

Many certificates of incorporation attempt to incorporate the DGCL's surplus requirement by permitting dividends, stock purchases or redemptions only out of "funds legally available." In *ThoughtWorks*, the Court of Chancery held that the term "funds legally available" is not synonymous with the term "surplus." Rather, it held that the term "funds legally available" encompasses three separate concepts:

- **Funds:** meaning cash.
- **Available:** meaning cash on hand or readily accessible through sales or borrowing.
- **Legally:** meaning cash that can be deployed without violating the DGCL or other statutory or common law restrictions, including the requirement that the corporation be able to continue as a going concern and not be rendered insolvent by the distribution.

This interpretation of funds legally available is broader than the general surplus requirement.

In addition (although most corporations already take this step), this interpretation requires that the board consider whether, in addition to the existence of surplus, any other limitations on making a distribution are imposed by law. The Court of Chancery, in *ThoughtWorks*, also identified a common law limitation from "redeeming... shares when the corporation is insolvent or would be rendered insolvent by the redemption."

However, in practice, many corporations already consider both prongs of insolvency recognized under Delaware law:

- The balance-sheet insolvency (the surplus test).
- The cash-flow insolvency (the ability to pay debts as they become due).

Significantly, in *Thoughtworks*, the Court of Chancery suggested that if the term funds legally available were omitted from a corporation's certificate of incorporation, a comparable limitation would be implied by law. This means that practitioners should be cognizant of the *ThoughtWorks* opinion even if the certificate of incorporation they are reviewing does not contain the term funds legally available.

Although the Court of Chancery's decision was affirmed by the Delaware Supreme Court, it was affirmed based on the alternative ground that, even if funds legally available were

equivalent to surplus, the corporation at issue did not have surplus. Therefore, the Delaware Supreme Court has still not yet weighed in on the subject.

## THE APPLICABLE STANDARD OF REVIEW

### General Fiduciary Duties to Stockholders

The decision of a board of directors to declare a dividend, approve a stock purchase program or exercise a redemption right generally falls under the business judgment rule. Under the business judgment rule, if a decision was undertaken by a disinterested board in good faith and in a fully informed manner, the decision will not be second-guessed by the courts unless it is irrational. Therefore, the decision of a board will not be disturbed for failure to comply with the directors' fiduciary duties absent facts that warrant extra scrutiny before the business judgment rule applies or that rebut the business judgment rule altogether.

For example, where a dividend declaration is part of a recapitalization or other program designed to defeat a hostile acquiror or a stock purchase program is designed to cement director control, enhanced scrutiny may be applied before the application of the business judgment rule. In conflict transactions (for example, if a board were to authorize the corporation to purchase stock held by the directors), the entire fairness standard of review may apply. For more information on fiduciary duties and the business judgment rule, see *Practice Note, Fiduciary Duties of the Board of Directors* (<http://us.practicallaw.com/6-382-1267>).

In the context of determining whether to second-guess a board's determination of surplus to assess whether the corporation would satisfy a put obligation to redeem preferred stock, the Court held that, if a disinterested board has "engaged deliberatively in the judgment-laden exercise of determining whether funds are legally available," the board's decision will not be disturbed for failure to comply with the DGCL unless a plaintiff proves that "the board acted in bad faith, relied on methods and data that were unreliable, or made a determination so far off the mark as to constitute actual or constructive fraud" (*ThoughtWorks, Inc., at 988*).

### Potential Personal Liability of Directors to the Corporation and Creditors and How to Protect Against that Liability

Section 174 of the DGCL provides that directors may be jointly and severally liable for any "wilful or negligent" violation of Section 173 (which prohibits dividends in violation of the DGCL, including Section 170) or Section 160 of the DGCL. Claims may be brought under Section 174 by the corporation or, if the corporation has dissolved or is insolvent, by the corporation's creditors. Although Section 102(b)(7) of the DGCL permits a corporation to include in its certificate of incorporation a provision exculpating directors from monetary liability for breaches of the duty of care, it expressly carves out exculpation of liability under Section 174 of the DGCL.

The statute of limitations for a claim under Section 174 is six years, starting at the time of payment of the unlawful distributions.



The directors can be held jointly and severally liable for the full amount of the unlawful distribution. However, a director that was absent at the time of the unlawful distribution or may have dissented from its approval may avoid liability by causing his dissent to be entered on the books containing the minutes of the applicable meeting. This must be done at the time of the meeting or immediately after the director has notice of the approval of the unlawful distribution. (*DGCL § 174(a).*)

If a director make a payment in satisfaction of a successfully asserted claim under Section 174, that director is entitled, to the extent of the payment, “to be subrogated to the rights of the corporation against stockholders who received” the unlawful distribution with knowledge of facts indicating that such distribution was unlawful “in proportion to the amounts received by such stockholders respectively.” (*DGCL § 174(c).*)

The DGCL does offer protection for directors who rely on officers and experts to assist them in the task of valuating the corporation’s assets and determining its liabilities. Section 172 provide that directors will be “fully protected” if the directors relied in good faith on the corporation’s records or on appropriate officers of the corporation and outside experts.

In practice, directors considering a dividend, stock purchase or redemption often request either a certification from the corporation’s chief financial officer (CFO) or an opinion from an outside financial advisor on, among other things:

- The value of the corporation’s assets and liabilities.
- Whether the corporation can pay its debts as they come due.
- Whether the corporation expects to have an unreasonably small amount of capital for the businesses in which it is engaged.

Whether the cost of obtaining an opinion of an outside financial advisor is advisable depends on the facts and circumstances of any given case, including, among other things:

- The size of the distribution to be made both as an actual dollar amount and as a percentage of the corporation’s total equity value.
- Whether debt will be incurred to make the distribution.
- The general knowledge of the corporation’s directors and officers regarding the state of the corporation’s finances.

If a financial advisor is engaged, counsel must take care in negotiating the financial advisor’s engagement letter and form of opinion.

In addition, the CFO often delivers a certification to the board addressing, among other things:

- Concurrence with the financial advisor’s opinion.
- That the assumptions on which the financial advisor’s opinion is based are accurate.
- That the CFO is not aware of any facts that would lead the CFO to believe that the financial advisor’s opinion overstates asset value or understates liabilities.

- That there have not been any material adverse changes in the company’s finances since the date of the most recent balance sheet or other financial information provided to the financial advisor.

If a valuation opinion from a financial advisor is not obtained, it is often advisable to obtain a certification from the CFO addressing the same core issues.

If the board is approving a long-term stock purchase program, it may consider requesting periodic updates as to surplus from the CFO. It is also advisable to require the CFO to certify that he will notify the directors if the CFO becomes aware of any change in the corporation’s financial position that would indicate to him that the facts previously conveyed to the board regarding the corporation’s financial situation are no longer true.

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