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Issuing Dividends Under Delaware Corporate Law

Under Delaware law, the power and authority to declare dividends resides with the board of directors of the corporation (Board). Section 170(a) of the Delaware General Corporation Law (DGCL) permits dividends to be declared out of two legally available sources: (1) out of surplus, or (2) if there is no surplus, out of net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year (so-called "nimble dividends"). However, dividends may not be declared out of net profits if "the capital of the corporation, computed in accordance with sections 154 and 244 of [the DGCL], shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets ... ." DGCL § 170(a)(2).

Dividend Payments Out Of Surplus

Section 170(a)(1) of the DGCL permits payment of dividends out of a corporation's "surplus," the excess of net assets over the corporation's capital as determined pursuant to Section 154 of the DGCL.

Under Section 154 of the DGCL, statutory "capital" is determined as follows: (1) for par value stock, the par value of the consideration received for the issuance of such stock constitutes capital unless the Board determines that a greater amount of the consideration received for such stock shall constitute capital; and (2) for stock with no par value, the entire consideration received for the issuance of such stock constitutes capital unless the directors, at the time of issuing shares for cash, or within 60 days after issuing shares for consideration other than cash, allocate a smaller portion of the total consideration to capital. DGCL, § 154. See *Jones v. First Nat'l Bldg. Corp.,* 155 F.2d 815, 816 (10th Cir. 1946). See also *Wright v. Heizer Corp.,* 503 F. Supp. 802, 810 (N.D. Ill. 1980). "Net assets" is "the amount by which total assets exceed total liabilities," though capital and surplus are excluded in determining net assets. DGCL § 154.

Thus, the funds available for a lawful dividend under the "surplus test" are calculated by subtracting the current value of total liabilities *and* the corporation's capital, calculated pursuant to the previous paragraph, from the current value of the corporation's total assets (see Valuing Net Assets of a Corporation, below).

Dividend Payments Out Of Net Profits

Section 170(a)(2) of the DGCL permits payment of dividends out of a corporation's net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year, *provided that* no dividends may be so declared if "the capital of the corporation, computed in accordance with sections 154 and 244 of this title, shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets ... ." DGCL § 170(a)(2).

This proviso is not clearly drafted and makes it difficult to determine whether a nimble dividend has been properly paid . Specifically, the proviso uses the term "capital" in two different contexts. Despite the first use, which refers to capital as computed under sections 154 and 244 of the DGCL (that is, statutory capital, a legal accounting concept that bears no relationship to value), this use of the term has been interpreted to mean the current value of the corporation's net assets. *See Wittenberg v. Federal Mining & Smelting Co.,* 138 A. 352, 353 (1927); *Morris v. Standard Gas & Elec. Co.,* 63 A. 2d 577, 581(1949). When the statute subsequently speaks of "the aggregate amount of the capital" represented by the outstanding preferred stock, it uses "capital" in the statutory sense, to mean the aggregate amount of the par value (or the stated value) of the issued and outstanding preferred stock. *Id*.

Thus, under Delaware law, a corporation cannot pay nimble dividends unless (1) the corporation has net profits for the current and/or preceding fiscal year; *and* (b) the current value of the corporation's net assets is equal to or greater than the aggregate amount of the par value (or stated value) of the corporation's outstanding preferred shares.

Valuing Net Assets Of A Corporation

Both the surplus test and the net profits test mandate a valuation of the corporation's net assets. Under Delaware law, however, there is no particular method mandated for such a valuation. While the value of the net assets of a corporation may be reflected on its books (based on generally accepted accounting principles), the books do not necessarily reflect the current market value of the corporation's assets and liabilities. Delaware courts have recognized this conflict and have permitted the directors of a corporation to "revalue" the assets and liabilities of the corporation when determining whether there are sufficient assets to make a lawful dividend under either the surplus or the net profits test. *See Morris*, 63 A.2d at 578 (finding that no single objective standard of asset valuation is necessary and that directors may "evaluate the assets on the basis of acceptable data and by standards that they are entitled to believe reasonably reflect present values"). Indeed, as long as the Board takes "great care to obtain data" and to exercise its "informed judgment" in arriving at a valuation of the corporation's net assets, a court will not disturb its valuation of the assets for purposes of declaring a dividend under either test, absent fraud or bad faith. *Id*. See also *Klang v. Smith's Food & Drug Centers, Inc.*, 702 A.2d 150, 152 (Del. 1997) (holding that "[d]irectors have reasonable latitude to depart from the balance sheet to calculate surplus, so long as they 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 that is not so far off the mark as to constitute actual or constructive fraud").

Therefore, intangible assets such as "goodwill" can play a pivotal role in determining whether a corporation can pass either the surplus or net profits test, despite the value of such assets reflected on the balance sheet. For example, a corporation's balance sheet might indicate that its total liabilities exceed its total assets and therefore would fail the surplus test; however, the board could reasonably determine that it has a surplus, based on the *present value* of the corporation's assets, by attributing additional value to intangible assets such as goodwill.

Liability Of Directors For Unlawful Distributions

Delaware corporate law makes the Board personally liable for its willful or negligent conduct in connection with the payment of an unlawful dividend. DCGL § 174(a). The directors are jointly and severally liable for the full amount of the unlawful payment to both the corporation and, in the event of dissolution or insolvency of the corporation, to its creditors. Director liability under this statute, however, is subject to a six-year statute of limitations, which begins running at the time of the unlawful payment. *Id*.

The declaration of a dividend is a matter generally entrusted to the business judgment of directors, and there is statutory protection for directors who exercise due care when deciding whether a dividend may be lawfully declared. *Klang*, 702 A.2d at 152. In fact, Section 172 of the DGCL provides that directors "shall be fully protected" if they rely in good faith upon the books of the corporation and "such information, opinions, reports or statements presented to the corporation by any of its officers or employees, or committees of the board of directors, or by any other person as to matters the director reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation, as to the value and amount of the assets, liabilities and/or net profits of the corporation or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid." DGCL § 172.

Directors are therefore protected from liability if they have relied in good faith upon the books and records of the corporation, or upon the report of an independent expert selected with reasonable care, when determining whether there are sufficient funds legally available to declare and pay a dividend either under the surplus or the net profits test.

Conclusion

Given the potential liability under sections 172 and 174 of the DGCL, directors of Delaware corporations must pay close attention to the provisions of the DGCL governing the proper declaration and issuance of dividends under either the surplus or the net profits test and the manner in which Delaware courts have interpreted such provisions.

If you have any questions regarding the proper issuance of dividends by a Delaware corporation, please contact any of the following attorneys:

Eric Dale
(203) 462-7568
edale@rc.com

Stephen Cooper
(203) 462-7576
scooper@rc.com

Travis Searles
(860) 275-8373
tsearles@rc.com