Articles + Publications | November 24, 2016

Leveraged Dividend Recapitalizations

WRITTEN BY

Andrew Hulsh | Soumya Sharma

This article was published in the Lexis Practice Advisor: Private Equity by Lexis Securities Mosaic on November 24, 2016. It is reprinted here with permission.

Introduction

A leveraged dividend recapitalization is a partial exit strategy of private equity sponsors, whereby proceeds of a new indebtedness incurred by a portfolio company are used to fund a dividend distribution to the portfolio company's stockholders. Interest among private equity sponsors and the growing appetite of lenders to provide debt financing to fund leveraged dividend recapitalizations reached a pinnacle in 2007, before the onset of the financial crisis in 2008, with dividend driven loan volume of $49.3 billion. After being virtually nonexistent during the two years following the financial crisis, there was a resurgence in dividend-driven loans beginning in 2010. According to Standard & Poor's Leveraged Commentary & Data, the years following 2010 saw dividend recap activity at astonishing rates and surpassing 2007 levels, with dividend driven loan and high yield bonds volume of $56.9 billion in 2012, $73.9 billion in 2013 and $53 billion in 2014.

The easing of credit markets coupled with the ability of financial institutions to finance dividend recaps at attractive interest rates have played a significant role in the comeback of leveraged dividend recapitalizations following the financial crisis. The excitement surrounding leveraged dividend recapitalizations has been tempered, however, with concerns about bankruptcy and related claims of fraudulent conveyance, breach by portfolio company directors of their fiduciary duties and payment of distributions in violation of statutory requirements under state corporate law.

The first bankruptcy of KB Toys, Inc. in 2004 may serve as a cautionary tale for leveraged dividend recapitalizations gone awry. In 2000, Bain Capital LLC and other investors (collectively, Bain) acquired KB Toys from Big Lots Stores Inc. In 2002, KB Toys was recapitalized by issuing significant secured and unsecured debt, and the proceeds were used to pay executive bonuses and dividends exceeding $120 million that ultimately flowed through the corporate structure and back to Bain. When KB Toys filed for bankruptcy almost two years later, creditors alleged that the dividend contributed in large part to the company's insolvency, was a result of self-dealing and outright fraud, and constituted a breach by the directors of KB Toys of their fiduciary duties. Though the case eventually settled, it still stands as an example of what can go wrong in a leveraged dividend recapitalization transaction.

Under appropriate circumstances, a leveraged dividend recapitalization is not illegal and may constitute an appropriate course of action to enable stockholders to receive a return of capital through a dividend. Indeed, if done correctly, a leveraged dividend recapitalization can maximize the present value of future earnings of a corporation. If a company's profitability, future earnings and capital structure are sound, a leveraged dividend recapitalization can be a useful tool to presently extract the expected future earnings of the company and enable the private equity sponsor stockholder to employ that cash to bolster another profiting enterprise. As this practice note will explore however, these are big "ifs." If a leveraged dividend recapitalization threatens a company's solvency, or appears to be a result of self-dealing, its creditors will find ample recourse in the law to protect their own interests. A prudent course of action requires a mindful approach to the minefield of potential issues surrounding the decision to effect a leveraged dividend recapitalization. The balance of this note examines the metrics used for identifying opportunities for executing a successful leveraged dividend recapitalization, the potential risks surrounding leveraged dividend recapitalizations, and risk mitigation strategies.

Identifying Appropriate Opportunities for Engaging in a Leveraged Dividend Recapitalization

A company with investors seeking a current return on their capital and having (1) conservative debt levels or debt at less market-friendly terms than its peers, (2) a history of consistent revenue growth, and (3) predictable cash flows presents a viable candidate for a leveraged dividend recapitalization. Once it is determined that the company is a suitable candidate for engaging in a leveraged dividend recapitalization, a variety of metrics can be evaluated by the management and the board to determine whether a leveraged dividend recapitalization is appropriate. A few of these metrics are discussed below and in essence speak to the capacity of the company to incur additional indebtedness at competitive levels.

The existence of one or more of the following conditions may favor an opportunity for a company to engage in a leveraged dividend recapitalization:

- Comparative debt to EBITDA. The total debt to EBITDA ratio of the company is below the average debt to EBITDA ratio of its peers.
- Comparative cost of debt. The existing indebtedness of the company is priced higher than the average pricing disclosed for similar indebtedness issued in recent leveraged dividend recapitalizations. This may provide an opportunity to refinance existing debt at lower rates, incur additional debt at competitive levels and distribute a substantial portion of the proceeds as a dividend.
- Debt covenants. The company's existing indebtedness is subject to more onerous financial covenants and ratios than currently available to the company for similar indebtedness. This may present an opportunity for the company to both refinance its existing indebtedness and incur additional indebtedness that forms the basis for a leveraged dividend recapitalization.

Potential Risks

If a company's solvency is threatened following an leveraged dividend recapitalization, then creditors may initiate actions to attempt to recover dividends that may have been improperly distributed on one or more of the following grounds, (1) that the dividend constituted a fraudulent conveyance, (2) the company was insolvent at the time the dividend was paid, and (3) the board of directors breached their fiduciary duty by declaring and paying the leveraged dividend recapitalization financed dividend.

Fraudulent Conveyance

A dividend paid in connection with a leveraged dividend recapitalization may be subject to claims of creditors under the U.S. Bankruptcy Code and the laws of most states (including Delaware) if it is deemed to be a fraudulent conveyance. While the issue of fraudulent conveyance most commonly arises in bankruptcy proceedings, under state law, the filing of a bankruptcy petition is not a prerequisite to a claim based on a fraudulent conveyance.

There are two types of fraud for purposes of fraudulent conveyance law: actual fraud and constructive fraud. Actual fraud exists where a transfer was made with actual intent to hinder, delay or defraud creditors. Constructive fraud is intended to deal with transfers that were not in the best interests of the transferor. The principal elements of constructive fraud are that the debtor:

- Received less than reasonably equivalent value in exchange for the transfer or obligation; and
- Such debtor (1) was insolvent at the time or became insolvent as a result of such transfer or obligation; (2) was left with unreasonably small capital; (3) intended to incur, or believed it would incur, debts beyond the debtor's ability to pay; or (4) made such transfer or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

Transfers that are deemed to be fraudulent conveyances that are made within two years prior to a bankruptcy filing are subject to a number of remedies, including (1) recapture of the dividend by the bankruptcy trustee into the bankruptcy estate, (2) attachment of the dividend or other property of the transferee, (3) an injunction against further disposition by the debtor or the transferee of any property, or (4) appointment of a receiver to take charge of any property of the transferee.

Insolvency at the Time of the Leveraged Dividend Recapitalization

While fraudulent conveyance statutes may scrutinize transfers that threaten the transferor's solvency, many states, including Delaware, separately require directors to declare and pay dividends either out of the corporation's surplus or, if there shall be no surplus, out of net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. Delaware law defines surplus as the excess of the company's net assets (being the amount by which total assets exceed total liabilities) over the amount determined to be capital by the board.

The responsibility for determining appropriate values for net assets and capital and whether there is a surplus ultimately falls to the board of directors. It is imperative that the board takes proactive steps to ensure that its determination complies with all applicable laws, because each director could be subject to personal liability under a claim for breach of fiduciary duty as discussed below.

Insolvency Tests

For purposes of the foregoing analysis, courts typically apply one of three solvency tests: the balance sheet test, the cash flow test, or the unreasonably small capital test.

- The balance sheet test deems a company insolvent when the sum total of its debts exceeds its assets at a fair market valuation.
- The cash flow test deems a company insolvent if, after effecting the transaction it is left in a cash flow position that will make it unable to satisfy its debts as they come due.
- The unreasonably small capital test sets the threshold at something short of what would qualify a company for

insolvency under the cash flow test. Under this test, a company is insolvent if it lacks an adequate capital cushion that would enable it to weather reasonably foreseeable business risks – the key difference in the two being that in the former, the company need only prove that it can provide sufficient cash flow to pay its existing creditors while in the latter the company must maintain a capital reserve in order to survive reasonably foreseeable (though currently unknown) risks.

In order to manage the risks associated with creditor claims, a company considering a leveraged dividend recapitalization should ensure that it can pass each of these tests both before and after the transfer.

Statutes of Limitations

Owing to the variations in statutes of limitations for various creditor actions, special attention should be paid to the timing of leveraged dividend recapitalizations. The US Bankruptcy Code looks back to any transfers that occurred within two years before the filing of a bankruptcy petition. The Delaware statute allows a creditor to make a claim for fraudulent transfer as long as four years after the date of the transfer. Under Delaware law, the statute of limitations for breach of director duty is broad, making directors jointly and severally liable for up to six years after the dividend has been disbursed. However, such a statute of limitations may also be tolled for periods when the defendant either actively concealed such knowledge from the plaintiff, or the plaintiff relied on the defendant's fiduciary role such that the plaintiff had no reason to suspect any wrongdoing. Thus, it is impossible to say with any confidence that a company is in the clear until at least six years after a leveraged dividend recapitalization, and even then the threat of litigation may persist.

Director Liability

Under Delaware law, a third-party creditor typically has no claim against the directors of a debtor corporation for breach of fiduciary duty. However, insolvency of a debtor corporation can give rise to a derivative claim of breach of fiduciary duty on the theory that satisfying the claims of a corporation's creditors is essential to maintaining the business as an ongoing concern and thus consistent with the fiduciary duty owed to its shareholders. The standing that such creditors gain is a result of insolvency and does not exist merely because the corporation is "navigating the zone of insolvency." See *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007). Therefore, a leveraged dividend recapitalization that leaves a corporation insolvent can also expose the directors to a breach of fiduciary duty claim from its creditors.

Under Delaware law, while directors are afforded a certain level of deference through the business judgment rule, the law nonetheless penalizes directors who act imprudently, thereby making them liable not only for the full amount of the dividend, but also for the accrued interest.

Risk Mitigation Strategies

Claims of breach of fiduciary duty and fraudulent conveyance are certainly not insurmountable, but are ones that should be carefully avoided. To avoid such liabilities, directors and corporations as a whole should seek and rely on truly independent solvency opinions and, if appropriate, create special committees charged to evaluate whether a leveraged dividend recapitalization is a justifiable transaction. While there is no safe harbor for leveraged dividend recapitalizations, best practices should involve a three-pronged approach focusing on (1) the solvency of the company both before and after the transaction, (2) complete independence by the board (or any special committee of the board that has been delegated the appropriate authority to consider a leveraged dividend recapitalization) and any financial advisors, and (3) business decisions made with the best information available. Each of these is discussed below.

Corporate Solvency

Ensuring that the company is solvent both before and after the leveraged dividend recapitalization is effected is essential to any risk mitigation strategy. This is true not only to mitigate the risk of liability arising under the bankruptcy law or fraudulent conveyance statute, but also to reduce the risk of director liability under a theory of breach of fiduciary duty, as insolvency is the prerequisite that gives rise to creditors' standing to bring such a claim. Best practices include obtaining a solvency opinion from an independent financial advisor. This solvency opinion should address the company's ongoing viability under each of the three insolvency tests discussed above. That is, the opinion should be sufficient to assure the board of directors that (1) the company's assets will exceed its liabilities immediately after the leveraged dividend recapitalization, (2) the company's projected cash flow will be sufficient to cover its ongoing debt payments, and (3) the company's will retain a capital cushion sufficient to weather any foreseeable problems in the future. In addition, the opinion should demonstrate that the leveraged dividend recapitalization is paid from the corporation's surplus.

The financial advisor providing the solvency opinion should work closely with the company's legal counsel to tailor its analysis to the specific legal requirements of the jurisdiction in which the company is incorporated. Moreover, the financial advisor should also have sufficient knowledge and experience in the particular industry of the company to make accurate cash flow and capital needs projections.

Independent Decision Making

Independence of the decision makers is essential to ensure that the transaction is consistent with the best interests of the corporation and its shareholders and is not influenced by self-dealing. Therefore, in the event there is any actual or perceived conflict of interest with respect to any member of the corporation's board of directors, an independent committee of directors should be formed to evaluate and consider the leveraged dividend recapitalization. Such committee should have full and complete access to its own financial and legal advisors counseling the proposed transaction. Moreover, any situations or circumstances where undue influence can be exerted upon the board or, if applicable, the independent committee, in connection with the decision making process should be minimized or removed. Thus it is imperative that the directors and the advisors be given sufficient autonomy, and that the transaction be properly documented (including through an appropriate record of all board or committee proceedings) so as not to eliminate the appearance of any undue influence.

Director independence may also help to ensure that the company obtains the benefit of the business judgment rule. If the decision to distribute a leveraged dividend recapitalization is made by directors who have acted on an informed basis, in good faith and with the honest belief that their actions are in the best interest of the corporation, then the decision is more likely to be evaluated under the business judgment rule. A court viewing the transaction in hindsight would thus afford the decision a favorable presumption and would be more likely to defer to the decision of an independent board or committee to engage in the leveraged dividend recapitalization.

Companies should consult with legal counsel to ensure compliance with all of the relevant laws surrounding dividend distribution. If directors, after reviewing all of these sources, do not agree with the decision to effect a leveraged dividend recapitalization, then they should make their dissent clear and such dissent should be reflected in the records of the board proceedings. Through these vigilant actions, directors will be more likely to demonstrate a good faith reliance on dependable sources, as well as a reasonable and prudent decision-making processes.

Best Information

Finally, it is crucial that all parties act with the best information available to them. Thus, a financial advisor rendering a solvency opinion should have as much access as possible to the company’s information, and the independent directors who are evaluating the decision to engage in a leveraged dividend recapitalization should base their decision upon all available information. In its complaint against Bain Capital dated January 13, 2006, in the Massachusetts Superior Court, the residual trust of KB Toys asserted that the solvency opinion delivered by the independent financial advisor was based on misleading projections derived from “overly optimistic and unreasonable” assumptions compared to historic trends and “incomplete financial information” and as such the solvency opinion was “inherently inadequate.”

Conclusion

The popularity of leveraged dividend recapitalizations waxes and wanes from year to year based on market fluctuations and the terms and availability of credit to finance the related dividend; however, the liability created by such transactions remains constant. Before initiating a leveraged dividend recapitalization, it is crucial that corporations and their respective boards consider the various risks, benefits, and other factors described above, and be vigilant in implementing appropriate processes and procedures to limit claims and liabilities associated with a leveraged dividend recapitalization. Despite the clear risks, leveraged dividend recapitalizations continue to be an attractive solution for private equity investors to address liquidity needs and desires, particularly in the face of constraining market conditions that may limit alternatives for providing such liquidity, and may very well continue to grow in popularity in the future, particularly in a low interest rate environment.

Content contributed by attorneys of Troutman Sanders LLP and Pepper Hamilton LLP prior to April 1, 2020, is included here, together with content contributed by attorneys of Troutman Pepper (the combined entity) after the merger date.

RELATED INDUSTRIES + PRACTICES

- Corporate
- Private Equity