



**Houlihan Lokey**

# Negative Equity and Solvency Opinions in Today's Market

**September 2022**

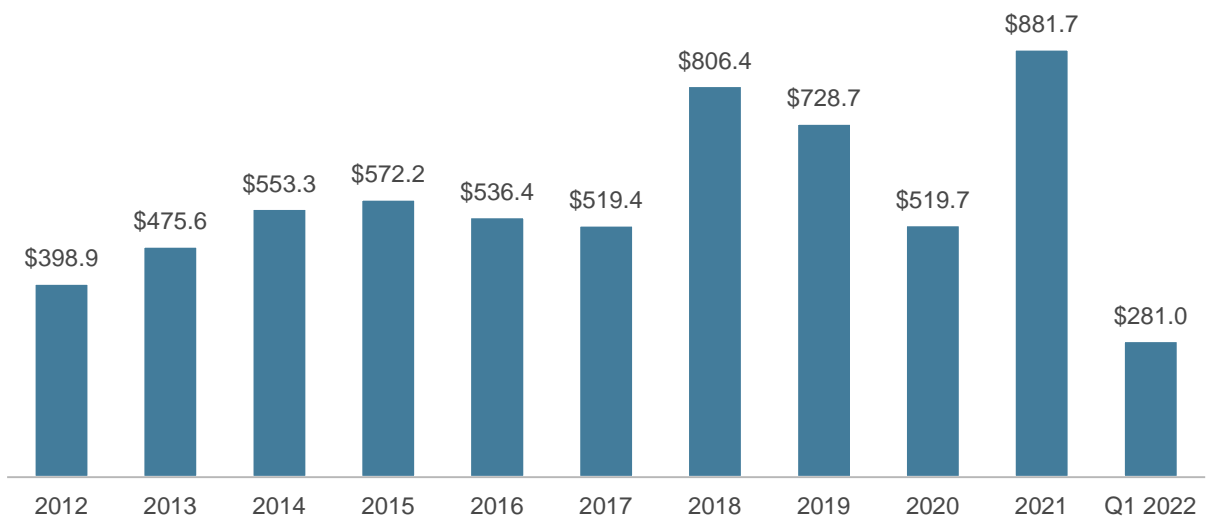


Houlihan Lokey is pleased to present its latest update on negative equity and solvency opinions.

## Introduction

Historically low interest rates over the past few years, along with a vast accumulation of cash on corporate balance sheets, have pressured companies to increase distributions to stockholders through dividends and stock repurchases. Owing to such pressure, S&P 500 companies paid out a record \$140.6 billion in dividends and repurchased a record \$281 billion in shares in the first quarter of 2022. In particular, stock repurchases are expected to remain strong, even as prices have declined, as reduced prices will increase the number of shares purchased and, as a result, increase earnings per share.

**2012 – Q1 2022 S&P 500 Share Repurchases (\$ in billions)**



Source: S&P Global.

Perhaps surprisingly, such record stockholder distributions have been affected against a backdrop of (i) geopolitical risks stemming from the Russian invasion of Ukraine, (ii) residual issues from the pandemic, (iii) supply chain bottlenecks, (iv) a strong U.S. dollar, and (v) soaring inflation that has rocked the equity markets and led the Fed and other central banks to raise interest rates.<sup>1</sup> For many companies, these troubling headwinds are having (and may continue to have) a deleterious impact on their businesses, potentially leading to the need to take goodwill impairments, which may result in negative stockholder equity on their balance sheets.<sup>2</sup>

Companies considering dividends or repurchases, and whose financial situation have been materially impacted by the pandemic and the recent macroeconomic and market headwinds, will need to carefully consider the prudence of paying dividends or repurchasing the company's shares.

## Dividends

Under Delaware law (the applicable corporate law for most publicly traded U.S. corporations), the power and authority to declare dividends resides exclusively with the board of directors of the corporation (the "Board").

Section 170 of the Delaware General Corporation Law (the "DGCL") permits the Board to declare dividends out of two available sources: either surplus or, 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. "Surplus" is the amount by which a corporation's capital is exceeded by its net assets as determined in accordance with DGCL Section 154. "Net assets," in turn, is defined by that Section as "the amount by which total assets exceed total liabilities," and "capital" is the aggregate par value of the company's previously issued (i.e., outstanding and treasury shares).

Unlike the declaration of dividends, however, stock repurchases do not necessarily require Board action; the Board almost invariably approves any material repurchases. In that regard, Section 160 of the DGCL prohibits a Delaware corporation from purchasing its own shares if the company's capital is "impaired" or the purchase would impair its capital. This prohibition has been interpreted to mean that a corporation may use only its surplus for stock repurchases. Thus, the ability of a corporation to affect either a dividend or a stock repurchase is limited by the amount of that corporation's surplus.

The responsibility for determining appropriate values for net assets (and hence whether there is a surplus) ultimately falls to the Board, and unfortunately, 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.

While the value of the net assets of the corporation may be indicated on its balance sheet (based on generally accepted accounting principles), the company's financial statements do not necessarily reflect the current market value of its assets and liabilities. The Delaware courts have recognized this anomaly and have permitted directors to "revalue" the assets and liabilities of the corporation (to present value) when determining whether there are sufficient assets to make a lawful dividend under the surplus test.<sup>3</sup>

Properly and accurately revaluing a company's assets and liabilities should be of great importance to the Board because Section 174 of the DGCL provides that directors may be jointly and severally liable for approving and paying a dividend or repurchasing stock in contravention of the applicable provisions of the DGCL.<sup>4</sup>

In this regard, the Delaware Supreme Court indicated in *Klang v. Smith's Food & Drug Centers, Inc.*, 702 A. 2d 150 (Del. 1997) 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."

While Section 102(b)(7) of the DGCL permits a corporation to exculpate its directors from monetary liability for breaches of the duty of care, that section expressly carves out exculpation of liability under Section 174.

## Solvency opinion

Fortunately, DGCL Section 172 provides that directors will be "fully protected" in determining the existence and amount of surplus if (among other things) the directors rely in good faith on outside experts that are selected with reasonable care by, or on behalf of, the corporation.

In connection with the declaration and payment of a dividend, or the repurchase of company shares, directors can demonstrate that they have met the requirements of Delaware law (and otherwise fulfilled their fiduciary duties) by obtaining an opinion from an independent solvency opinion expert. Additionally, such an opinion can help mitigate the Board's exposure to the potential risk of fraudulent conveyance liability in actions brought by the company's creditors.

A solvency opinion can be relied on by the Board to demonstrate that (i) the company's assets will exceed its liabilities immediately after the dividend or repurchase, (ii) the company's projected cash flow will be sufficient to cover its ongoing debt payments, (iii) the company will retain a capital cushion sufficient to weather any foreseeable problems in the future, and (iv) the dividend or repurchase is made from the company's surplus.

Since pioneering the use of solvency opinions in the mid-1980s, Houlihan Lokey has rendered hundreds of solvency and capital adequacy opinions on behalf of Boards of both public and private companies. Our expertise in the areas of valuation, restructuring, and mergers and acquisitions provides a strong foundation for the issuance of such opinions, as does our significant experience in navigating complex issues such as underfunded pension obligations, environmental and product-related liabilities, employee claims and other contingent liabilities, and our record of success in defending our opinions in court.

See below for a selection of recent transaction highlights.<sup>5</sup>



<sup>1</sup> In the future, stock repurchase may be impacted by the 1% excise tax on buybacks imposed by the so-called "Inflation Reduction Act."

<sup>2</sup> Per CapIQ, there are currently 928 publicly traded companies with negative stockholder's equity. Over 300 of such companies have taken goodwill impairments in the past 18 months.

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<sup>4</sup> While Section 102(b)(7) of the DGCL permits a corporate to exculpate its directors from monetary liability for breaches of the duty of care, that section expressly carves out exculpation of liability under Section 174.

<sup>5</sup> Tombstones included herein represent transactions closed from 2018 forward.

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\*Source: Refinitiv. Announced or completed transactions.

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