PROTECTING ALL CORPORATE STAKEHOLDERS:FRAUDULENT TRANSFER LAW AS A CHECK ON CORPORATE DISTRIBUTIONS

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ABSTRACT

"Give me a place to stand, and [with a lever] I will move the whole world[]," boasted Archimedes, highlighting the power of leverage.[1] *In the context of corporate finance, leverage allows a company to use borrowed money to turn a profit by taking advantage of lower interest rates.*[2] *The lever, or an infusion of "cheap" debt money, often permits a business to grow revenues by expanding operations or turn larger profits off of working capital.*[3] *Not all borrowing empowers one to move the whole world though, and "a place to stand" requires maintaining a healthy financial condition and a robust debt-to-equity ratio.*[4]

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[1] NICHOLAS RESCHER, A JOURNEY THROUGH PHILOSOPHY IN 101 ANECDOTES 61 (2015); *see Leverage*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "leverage" as "[p]ositional advantage that may well help a person get what he or she wants from others; effectiveness.").

[2] *Leverage*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "leverage" as "[t]he use of credit or borrowed funds (such as buying on margin) to improve one's speculative ability and to increase an investment's rate of return.").

[3] JEFFREY J. HAAS, CORPORATE FINANCE 157–58 (2014) (reviewing examples of the leverage effect).

[4] *See id.* at 160–61 (discussing optimal levels of debt and highlighting theories under which a company's capital structure is irrelevant to its market valuation); *see generally* Michael Milken, *Why Capital Structure Matters Companies that Repurchased Stock Two Years Ago are in a World of Hurt*, WALL ST. J. (Apr. 21, 2009, 12:01 AM), https://www.wsj.com/articles/SB124027187331937083 (opining that "capital structure significantly affects both value and risk"); *but see* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 268–71 (1958) (formulating what has become known as M&M Irrelevance Proposition I: a firm's capital structure is irrelevant to its value, which is determined based on the discounted present value of operational profits).

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I. INTRODUCTION

A few years prior to its 2019 liquidation, Payless ShoeSource ("Payless"), a 63-year-old discount shoe retailer, investigated whether a special dividend the company recently paid to its shareholders caused or exacerbated its insolvency.[5] In its second bankruptcy in the past two years, the private-equity-backed Payless finally announced that it was going out

[5] Nathan Bomey, *Payless ShoeSource Files Chapter 11 Bankruptcy with Plans to Close All U.S. Stores*, USA TODAY (Feb. 19, 2019, 7:49 AM), https://www.usatoday.com/story/money/2019/02/19/payless-shoesource-chapter-11-bankruptcy/2913106002/; T.J. Hope, *Bankrupt Payless Settles with Unsecured Creditors in Dividend Dispute*, STOUT (Oct. 6, 2017), https://www.stout.com/en/insights/commentary/bankrupt-payless-shoesource-investigates-dividends-to-pe-sponsors/.

of business, closing all 2,100 of its US locations and shutting down its online operations.[6] Financial fiascoes of brick-and-mortar retailers are certainly nothing new: many have recently caved in under the pressure of flourishing and newly emerging competition from online platforms.[7] Some of these failing retailers were backed by various private equity funds ("PE funds")—investors well-known for their quick-profit motivated acquisitions.[8] PE funds' inability to turn a profit on their investment in these traditional retailers has given rise to a fairly new, and a rather troubling, phenomenon—debt-funded distributions.[9] The distributions to shareholders may be in the form of a share buyback or a dividend.[10]

In the case of Payless, while the corporation struggled to meet its debt repayment obligations, shutting down its stores across the country, two private equity funds—Golden Gate Capital Inc. and Blum Capital Partners—managed to gain on their investment in the failing retailer.[11] These investors leveraged Payless' balance sheet by having the company borrow several hundred million dollars from the public.[12] The debt-saddled entity was then forced to pay out a special dividend in the amount of $350 million to the PE funds.[13] By the third quarter of 2017, PE funds paid themselves $15.31 billion in debt-funded dividends, which was nearly equal to the total for all of 2016.[14] As of November of 2018, more

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[6] Ahiza Garcia, *Payless is Closing All Its 2,100 US Stores*, CNN (Feb. 18, 2019, 9:49 AM), https://www.cnn.com/2019/02/15/business/payless-closing-stores-bankrupt/index.html.

[7] *See* Wolf Richter, *Here's Which Brick-and-Mortar Retailers are Getting Hit the Hardest*, BUS. INSIDER (May 19, 2018, 11:02 AM), https://www.businessinsider.com/brick-and-mortar-retailers-getting-hit-the-hardest-2018-5 (pointing out recent trends in retail); Steve Olenski, *The Old Retail Playbook Is Dead*, FORBES (May 1, 2018, 12:49 PM), https://www.forbes.com/sites/steveolenski/2018/05/01/the-old-retail-playbook-is-dead/#79c5a84230ee.

[8] Hope, *supra* note 5 (pointing out that more than thirty PE-backed retailers recently filed for bankruptcy).

[9] *Id.*

[10] In this Article, the term "distribution" will be used interchangeably with "dividend." Distributions also encompass stock repurchases or redemptions, but the analysis provided in this Article equally applies to all distributions.

[11] Nabila Ahmed & Sridhar Natarajan, *Private Equity Wins Even When It Loses, Thanks to Debt Markets*, BLOOMBERG (Mar. 20, 2017, 11:50 AM), https://www.bloomberg.com/news/articles/2017-03-20/private-equity-wins-even-when-it-loses-thanks-to-debt-markets; Jessica DiNapoli & Tracy Rucinski, *Exclusive: Payless Settles Creditor Dispute over Dividends-Sources*, REUTERS (June 20, 2017, 9:45 PM), https://www.reuters.com/article/us-payless-bankruptcy-privateequity/exclusive-payless-settles-creditor-dispute-over-dividends-sources-idUSKBN19C05W.

[12] DiNapoli & Rucinski, *supra* note 11.

[13] Hope, *supra* note 5.

[14] Tim Cross, *With Investor Demand Intense, Private Equity Shops Tap Leveraged Loan Mart for Dividends*, S&P GLOB. MKT. INTELLIGENCE (Oct. 13, 2017, 3:08 PM),

than $30 billion in borrowed funds was paid out by companies to their PE owners.[15] Studies show that 25% of 481 large Chapter 11 filings over six years (from mid-2011 through mid-2017) were by PE-owned companies.[16] In 2017, 40% of Chapter 11 filers were owned by PE funds.[17]

While the benefits of leverage are well-known, an already-struggling entity burdened by large amounts of debt to pay shareholder dividends becomes even more likely to fail.[18] Its insolvency and subsequent bankruptcy are sure to have a detrimental effect not only on the company's creditors but on its other stakeholders, such as employees, suppliers, and possibly the community at large. Even if highly leveraged entities manage to survive, payouts to shareholders deplete cash that could be used for a myriad of other purposes, such as reinvestment in operations or contributions to employee pension funds.[19]

The two bodies of law that impose restrictions on dividend payouts are unfortunately inconsistent. Though present-day corporate law statutes impose restrictions on dividends, these limitations do not accord with fraudulent transfer laws. If an entity that pays a dividend becomes insolvent, the bankruptcy estate may pursue the shareholders in a clawback action to recover the distributions as fraudulent transfers.[20] Under the current fraudulent transfer scheme, shareholders become liable to return the distributions if the corporation received no reasonably equivalent value in the transaction, and if the transaction took place while the corporation

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http://www.leveragedloan.com/investor-demand-intense-private-equity-shops-tap-leveraged-loan-mart-dividends/.

[15] Davide Scigliuzzo, *A Private Equity Firm Turns Unpaid Health Bills Into Big Payout*, BLOOMBERG (Nov. 5, 2018, 6:00 AM), https://www.bloomberg.com/news/articles/2018-11-05/pamplona-said-to-turn-unpaid-bills-into-dividends-in-health-deal.

[16] Chuck Carroll & John Yozzo, *Private Equity Has a Retail Problem*, 37 AM. BANKR. INST. J. 46 (Jan. 2018), https://www.fticonsulting.com/~/media/Files/us-files/insights/articles/private-equity-has-retail-problem.pdf.

[17] *Id.*

[18] *See* Christine Idzelis, *The Most Aggressive Buyout Firms Taking Debt-Financed Dividends*, INST. INV'R (Oct. 18, 2018), https://www.institutionalinvestor.com/article/b1bfrk75zvtz9d/The-Most-Aggressive-Buyout-Firms-Taking-Debt-Financed-Dividends ("A Moody's report shows which buyout firms are 'particularly aggressive' in taking debt-financed dividends from the companies they own — potentially jeopardizing their ability to navigate a downturn.").

[19] *See, e.g.*, Sunny Oh, *5 Companies that Spent Lavishly on Stock Buybacks While Pension Funding Lagged*, MARKETWATCH (Oct. 20, 2018, 6:25 AM), https://www.marketwatch.com/story/5-companies-that-spent-lavishly-on-stock-buybacks-while-pension-funding-lagged-2018-10-20 (noting that while share repurchases increased, companies failed to contribute to employee pension plans).

[20] *See* 11 U.S.C. §§ 544, 548 (2012).

was insolvent or made the corporation insolvent.[21] Counterintuitively, directors who authorized these fraudulent-transfer dividends are not automatically liable under fraudulent transfer laws.[22] Liability for the directors as the decision-makers authorizing the distribution hinges on whether corporate-law distribution restrictions were violated.[23] Although the modern version of the Model Business Corporation Act ("MBCA") comes closer in line with fraudulent transfer standards,[24] some states—most significantly, Delaware—still use the so-called "impairment of capital" test.[25] While the modern statutes prohibit distributions when the corporation is insolvent, the impairment of capital test allows directors great flexibility in authorizing distributions that may well violate fraudulent transfer laws.[26]

To prevent abusive dividend practices that are injurious to the corporation as a whole, along with all of its stakeholders, states should revise their corporate-law restrictions on dividends to require that distributions do not violate fraudulent transfer laws. This restriction on dividends would align corporate law with fraudulent transfer statutes, avoiding the absurd results of holding shareholders liable in scenarios in which directors would not be. It would also provide much-needed clarity from a planning perspective. This Article therefore recommends that fraudulent transfer standards be incorporated into dividend restrictions under corporate law.

Part II of this Article defines dividends in general and reviews the business logic behind declaring dividends. It also surveys corporate-law statutes restricting dividend declaration with the focus on the antiquated "impairment of capital" test and its current application by courts. Additionally, Part II reviews the circumstances when unlawful dividends give rise to director liability. Part III of this Article focuses on debt-funded

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[21] *See id.* § 548.

[22] *See id.* § 550 (imposing liability on transferees).

[23] *See, e.g.*, DEL. CODE ANN. tit. 8, § 174(a) (2016) (imposing liability on directors for unlawful distributions).

[24] *See* MODEL BUS. CORP. ACT § 6.40 (AM. BAR ASS'N BUS. L. SECTION 2016) (using two tests of insolvency).

[25] *See* DEL. CODE ANN. tit. 8, §§ 154, 160, 170(a)(1) (2016) (applying the impairment of capital test to corporate repurchases and dividends).

[26] *See id.* § 170; Klang v. Smith's Food & Drug Ctrs., Inc., 702 A.2d 150, 152 (Del. 1997) ("Corporations may revalue assets to show surplus, but perfection in that process is not required. Directors 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 of the surplus that is not so far off the mark as to constitute actual or constructive fraud.").

dividends, explaining the general reasons for leveraged recapitalizations and outlining the dangers of funneling borrowed money to corporate shareholders. One such danger inherent in the practice of debt-funded dividends is identified in Part IV as fraudulent transfer avoidance. Finally, Part V outlines the inconsistent standards imposed by some corporate-law statutes and stringent clawback rules in fraudulent transfer avoidance. It proposes incorporating fraudulent transfer laws into restrictions on distribution statutes.

II. CORPORATE DISTRIBUTIONS IN GENERAL

A. *Dividends Generally*

A dividend is a distribution by a corporation of some of its assets to the corporation's shareholders.[27] Such distributions are in proportion to their share ownership.[28] They may be paid out in cash, other property, or corporate stock.[29] The term "dividend" has recently been replaced with a broader concept of a "distribution" in most corporate law statutes, to capture other transfers by a corporation of its assets to its shareholders such as stock repurchases.[30] Economically, the effect of both dividend payouts and corporate repurchases is similar, for purposes of this Article, because shareholders in both instances receive a payout of corporate assets.

Declaring dividends is reserved for the board of directors and is generally in their discretion, constrained by restrictions under state law on dividends, any limitations imposed in the corporation's charter, as well as directors' fiduciary duties.[31] Directors are subject to their traditional duty of care in deciding whether to reinvest operating profits or pay out some

[27] *See generally* 11 FLETCHER CYC. CORP. § 5318 (2018) (providing an overview of dividends and other distributions).

[28] *Dividend*, BLACK'S LAW DICTIONARY (11th ed. 2019), (defining "dividend" as "A portion of a company's earnings or profits distributed pro rata to its shareholders, usu[ally] in the form of cash or additional shares.").

[29] DEL. CODE ANN. tit. 8, § 173 (2016); MODEL BUS. CORP. ACT § 1.40 (AM. BAR ASS'N BUS. L. SECTION 2016).

[30] *See, e.g.*, MODEL BUS. CORP. ACT § 1.40 (AM. BAR ASS'N BUS. L. SECTION 2016) ("A distribution may be in the form of a payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; a distribution in liquidation; or otherwise.").

[31] *Id.* § 6.40(a); DEL. CODE ANN. tit. 8, § 170(a) (2016); N.Y. BUS. CORP. LAW § 510(b) (McKinney 2008); 11 FLETCHER CYC. CORP. § 5320 (2018).

of the cash to the shareholders.[32] Directors who are also shareholders are generally not disqualified from a vote on dividend declaration.[33]

As a matter of business strategy, mature corporations may pay regular dividends to satisfy their investors' desire for steady income.[34] Receiving regular income may be attractive to some investors who prefer to be able to make their own decision for reinvestment of the profits generated by the corporation. This preference is captured by the so-called "bird in the hand theory."[35] Directors are responsive to shareholder preferences as regular dividends may make the company more attractive to investors.[36] The ability to pay out dividends generally creates bullish perceptions and drives up the price of the stock.[37]

There are some compelling reasons for reinvesting the profits, however. Dividends are fairly uncommon in start-up businesses, which usually need the cash to fund growth.[38] Well-established companies with a steady track record, such as Berkshire Hathaway, may also decide to reinvest their earnings to either fund development or purchase assets or other companies.[39] Some well-known companies never pay dividends as

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[32] *See* Hill v. State Farm Mut. Auto. Ins. Co., 83 Cal. Rptr. 3d 651, 671 (Ct. App. 2008) ("In considering whether to declare dividends, [the company] was bound by a duty of care, requiring the Board to make decisions in a prudent manner.").

[33] Hannigan v. Italo Petroleum Corp., 77 A.2d 209, 212–13 (Del. 1949).

[34] HAAS, *supra* note 3, at 285.

[35] *See generally* Richard A. Booth, *Junk Bonds, the Relevance of Dividends and the Limits of Managerial Discretion*, 1987 COLUM. BUS. L. REV. 553, 561 (1987) (summarizing the essence of the bird-in-the-hand theory); *but see* Daniel R. Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 702 (1981) (summarizing the dividend-irrelevance hypothesis and noting that "[i]f a firm retains earnings rather than paying a dividend, the price of the firm's shares will rise accordingly. A shareholder who wants current income can simply sell part of his holdings.").

[36] HAAS, *supra* note 3, at 285 ("When a company pays out dividends to its stockholders, that payment has a 'signaling effect' on the market. An increase in dividend payout is a 'bullish' or positive signal, generally indicating management's favorable outlook for the company's future profitability and growth.").

[37] *But see* Fischel, *supra* note 35, at 701 ("In fact, the overwhelming weight of theoretical authority and recent empirical evidence does not support the proposition that dividend policy affects share prices apart from earnings."); Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411, 414 (1961) (formulating their famous "irrelevance theorem" and claiming that a company's dividend policy has no effect on its share price or shareholder returns).

[38] Daniel J. Morrissey, *Another Look at the Law of Dividends*, 54 U. KAN. L. REV. 449, 451–52 (2006) (stating that "[Y]oung, high-growth companies typically attract investors who understand that such firms will retain all their earnings to fund expansion.").

[39] Dan Caplinger, *Will Berkshire Hathaway Finally Pay a Dividend in 2019?*, THE MOTLEY FOOL (Apr. 21, 2019, 8:29 PM), https://www.fool.com/investing/2019/01/20/will-berkshire-hathaway-finally-pay-a-dividend-in.aspx.

a matter of policy, and investors purchase the stock with that expectation.[40] A change in long-standing dividend policy will usually affect share prices because investors will perceive it as evidence of a change in management's view on a company's future.[41] Technology company Apple Inc. has recently started paying out some of the largest cash distributions to its owners in the form of both dividends and repurchases—a change from its no-dividend strategy prior to March of 2012.[42]

Courts are very deferential to the directors' business judgment on whether or not to pay dividends.[43] Shareholders have no right to demand that directors distribute corporate profits instead of reinvesting them.[44] Lawsuits to force the directors to declare dividends typically fail, unless the decision not to pay dividends is the result of fraud, bad faith, or abuse of discretion.[45] Additionally, there is no enforceable contractual right to dividends until they have been declared by the directors.[46] After the dividend has been declared, a shareholder is treated as an unsecured creditor up to the amount of the dividend.[47]

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[40] Joshua Brustein, *Kickstarter Just Did Something Tech Startups Never Do: It Paid a Dividend*, BLOOMBERG (Jun. 17, 2016, 9:52 AM), https://www.bloomberg.com/news/articles/2016-06-17/kickstarter-just-did-something-tech-startups-never-do-it-paid-a-dividend ("More than 80 percent of the companies in the S&P 500 pay dividends, and many smaller companies do, too.").

[41] Miller & Modigliani, *supra* note 37, at 430 ("[W]here a firm has adopted a policy of dividend stabilization with a long-established and generally appreciated 'target payout ratio,' investors are likely to (and have good reason to) interpret a change in the dividend rate as a change in management's views of future profit prospects for the firm.").

[42] Lou Carlozo, *Why Apple Dividends Have a Delicious Future*, U.S. NEWS & WORLD REPORT (Mar. 13, 2018), https://money.usnews.com/investing/stock-market-news/articles/2018-03-13/apple-inc-aapl-stock.

[43] *See* Hill v. State Farm Mut. Auto. Ins. Co., 83 Cal. Rptr. 3d 651, 693 (Ct. App. 2008) ("The fact that a corporation has earned profits out of which directors might lawfully declare a dividend . . . is insufficient alone to justify judicial intervention compelling a declaration and payment.") (citation and internal quotation marks omitted); *but see* Dodge v. Ford Motor Co., 170 N.W. 668, 671, 684 (Mich. 1919) (ordering Ford to pay out dividends and concluding that the corporation must be run for the benefit of its stockholders, after Henry Ford had publicly announced that his ambition "'to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes.'").

[44] 11 FLETCHER CYC. CORP. § 5319 (2018).

[45] *Id.* § 5325; Gabelli & Co. v. Liggett Grp. Inc., 479 A.2d 276, 280 (Del. 1984).

[46] *See, e.g.*, Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1175 (Del. 1988); *see generally* HAAS, *supra* note 3, at 280 (reviewing general requirements for an issuance of dividends).

[47] MODEL BUS. CORP. ACT § 6.40(f) (AM. BAR ASS'N BUS. L. SECTION 2016) ("A corporation's indebtedness to a shareholder incurred by reason of a distribution made in accordance with this section is at parity with the corporation's indebtedness to its general, unsecured creditors except to the extent subordinated by agreement."); *see* Caleb & Co. v. E.I. DuPont de Nemours & Co., 615 F. Supp. 96, 105–06 (S.D.N.Y. 1985) (applying Delaware law).

B. *Restrictions on Distributions*

Even though directors enjoy broad discretion in authorizing dividends, their power to declare one is not absolute.[48] While the focus of this Article is on restrictions imposed by state corporate-law statutes, as a matter of private ordering, corporations may limit distributions in their organizational documents[49] or contractually.[50]

State corporate-law statutes impose various restrictions on dividend distributions.[51] The goal of these restrictions is the protection of the creditors by preserving capital to repay debts owed to them.[52] The Supreme Court of the United States explained that corporate assets are held in trust to repay corporate debts, noting that "the rule is well settled that stockholders are not entitled to any share of the capital stock nor to any dividend of the profits until all the debts of the corporation are paid."[53] Today's statutes permit distributions even if a corporation has outstanding debt obligations, provided some capital is preserved for the creditors. This Article will review the traditional approach, or the so-called "impairment of capital test," and the modern statutes, which follow a version of the MBCA.

1. The Impairment of Capital Test

The traditional approach, the "impairment of capital test," restricts the corporation's ability to pay dividends out of legal capital.[54] Its rules are cumbersome, antiquated, and fail to achieve their goal of creditor protections.[55] The impairment of capital test has unfortunately allowed

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[48] *See generally* JAMES D. COX & THOMAS LEE HAZEN, TREATISE ON THE LAW OF CORPORATIONS § 20:12 (3d ed. 2018).

[49] *See* MODEL BUS. CORP. ACT § 6.40(a) (AM. BAR ASS'N BUS. L. SECTION 2016).

[50] *See* ALAN R. PALMITER, CORPORATIONS, 657–58 (8th ed. 2015) (discussing how creditors often bargain for various restrictions in their contracts and how negative covenants limit the corporation's ability to pay out dividends either altogether or in the absence of the creditors' explicit consent).

[51] *See generally* COX & HAZEN, *supra* note 48.

[52] *See generally* PALMITER, *supra* note 50, at 647–58 (discussing limitations on corporate distributions).

[53] Chicago, R.I. & P.R. Co. v. Howard, 74 U.S. 392, 409–10 (1868).

[54] *See* Sapperstein v. Wilson & Co., 182 A. 18, 20 (Del. Ch. 1935) ("[T]he capital of a corporation shall not be impaired by the paying out of dividends to stockholders.").

[55] *See id.* (stating that the rule against the impairment of capital is "in the interest of creditors").

shareholder payouts that eventually lead to insolvency and has been the bane of judges, practitioners, law professors, and law students alike.[56]

The legal capital requirement stems from rules originally governing corporations.[57] Early corporations were created by legislation through a special charter.[58] One of the prerequisites for a legislative grant of a charter was allocation and preservation of a certain amount of capital—"legal capital"—for the protection of the creditors.[59] Under this traditional approach, corporate distributions are limited to surplus, forbidding payouts out of legal capital.[60]

Even though there is no generally imposed requirement for maintaining a physical legal capital account, some corporate statutes still require that legal capital be reflected on the balance sheet.[61] Under the impairment of capital test, distributions are limited to corporate surplus,[62] or the excess of assets over the sum of liabilities and legal capital. Legal capital equals par value multiplied by the number of outstanding shares.[63] The notion of legal capital is thus tied to another antiquated construct: that of par value.

Par value refers to the minimum value that must be paid as consideration for stock.[64] Par value is required to be listed in the certificate

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[56] *See, e.g.*, MATTHEW G. DORE, 6 IA. PRAC., BUSINESS ORGANIZATIONS § 30:5 (2018-2019 ed.) (providing the background for Iowa's restrictions on distributions) ("The traditional limitations were based on a complicated series of capital and surplus accounts that resulted, in part, from statutory requirements that corporate shares carry a stated par value. To describe comprehensively the statutory rules defining these accounts would not be productive.").

[57] *See generally* COX & HAZEN, *supra* note 48, § 2:5 (reviewing the evolution of corporation chartering laws).

[58] *See id.*

[59] BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL 7 (4th ed. 2013).

[60] *See* DEL. CODE ANN. tit. 8, § 170(a)(2) (2016).

[61] *See id.*

[62] *See id.* § 170(a)(1) ("The directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares of its capital stock . . . [o]ut of its surplus, as defined in and computed in accordance with §§ 154 and 244 of this title . . . ."). Section 170 also permits directors to declare and pay "nimble" dividends out of net profits in cases when there is no surplus. *Id.* § 170(a)(2). The profits must be for the current or previous fiscal year. *Id.*

[63] The number of shares a corporation decides to issue is "arbitrary, because no matter how many shares into which you slice a pie, the size of the pie remains the same." MANNING & HANKS, *supra* note 59.

[64] *See* DEL. CODE ANN. tit. 8, § 153(a) (2016) ("Shares of stock with par value may be issued for such consideration, having a value not less than the par value thereof, as determined from time to time by the board of directors, or by the stockholders if the certificate of incorporation so provides.").

of incorporation, unless the corporation chooses to issue no-par stock.[65] Par value today is of no practical importance, has nothing to do with the stock's economic value, and is an entirely arbitrary number assigned to corporate stock.[66] Most modern corporations will limit share par value to a nominal amount, typically a fraction of a dollar or sometimes even a penny.[67] When new stock is issued initially, the stated par value will be multiplied by the number of issued shares, the product to be allocated to the legal capital account.[68] If no par value is specified in the organizational document, some amount must nonetheless be assigned to the corporation's so-called "stated capital" account.[69] Unless some amount generated by the stock issuance is assigned to the stated capital account, the entire proceeds of the stock issue will be locked up as stated capital.[70]

To demonstrate how the impairment of capital test applies in practice, imagine a hypothetical Delaware corporation whose balance sheet reflects $6 million in assets and $2 million in liabilities. Of the $6 million assets, $1 million was raised by the corporation through selling 1,000 shares of stock. The shares were purchased by 10 individuals, each of whom invested $100,000. Thus, each share of stock was issued by the corporation for $1,000. To calculate the amount of legal capital, it is necessary to consult the certificate of incorporation to verify the stock's par value. If par value was nominally assigned a $1 amount, then the legal capital for this corporation will equal $1 par value times 1,000 shares of stock, equaling $1,000. To calculate the surplus, or the amount statutorily authorized for corporate distributions, one would subtract from the $6 million in assets the sum of the corporation's liabilities and its legal capital:

$$6{,}000{,}000 - (2{,}000{,}000+1{,}000) = 3{,}999{,}000.$$

Therefore, under the impairment of capital test, this corporation can distribute to its shareholders $3,999,000, or the surplus.

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[65] DEL. CODE ANN. tit. 8, § 151(a) (2017); N.Y. BUS. CORP. LAW § 501(a) (McKinney 1996).

[66] MANNING & HANKS, *supra* note 59 ("The par value per share is also an arbitrary number, set by the incorporators of the corporation.").

[67] *See, e.g.*, Alphabet, Inc., Amended and Restated Certificate of Incorporation (Oct. 2, 2015) (listing $0.001 per share for all of its classes of stock).

[68] HAAS, *supra* note 3, at 281.

[69] *Id.*

[70] *Id.* at 281–82; *see, e.g.*, N.Y. BUS. CORP. LAW § 506(b) (McKinney 1963) ("Upon issue by a corporation of shares without par value, the entire consideration received therefor shall constitute stated capital unless the board within a period of sixty days after issue allocates to surplus a portion, but not all, of the consideration received for such shares.").

The antiquated impairment of capital test does not meet its original purpose of creditor protection and provides no meaningful restriction on distributions.[71] Modern statutes do not impose any minimum amount on par value, and thus any legal capital required to be maintained by the statute would be of no benefit to creditors. Nor does this test account for the debtor's ability to meet its debt obligations. This is the focus of the equitable insolvency test employed by modern statutes and discussed below: how much cash or other liquid assets are readily available to satisfy the debtor's current obligations? If the hypothetical corporation owes $2,000,000 in short-term debt, or debt due within a year, and $5,000,000 of its $6,000,000 in assets is illiquid assets (such as real estate or plants and equipment), it does not have enough cash to pay its debts as they become due. Its limited cash flow makes it insolvent. In a jurisdiction that adopts the latest version of the MBCA, dividends would be prohibited.[72] Yet, the same corporation would be authorized, under Delaware law, to make a distribution of its entire surplus, or excess of assets over the sum of liabilities and legal capital.[73]

In addition to the virtual absence of statutory limitations on dividends, Delaware courts have been very deferential when reviewing a board of directors' application of the impairment of capital test.[74] The leading decision is an en banc opinion by the Delaware Supreme Court in *Klang v. Smith's Food & Drug Centers, Inc*. ("*Klang*").[75] In that case, the Court applied a liberal standard in evaluating directors' authorization of a payout, allowing the board "reasonable latitude to depart from the balance sheet to calculate surplus."[76] The Court required that directors "evaluate assets and liabilities in good faith, on the basis of acceptable data, by methods that they reasonably believe reflect present values."[77] Under this liberal standard, the directors' determination of surplus cannot be "so far off the mark as to constitute actual or constructive fraud."[78]

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[71] *See, e.g.*, COX & HAZEN, *supra* note 48, § 20:11 ("Historically, statutes have attempted to provide for the establishment, contribution, and maintenance of some margin of asset values over liabilities for the protection of creditors. But because these statutes did not keep up with changes in generally accepted accounting practices and the insights of modern finance, legal capital has become a dated dividend restriction.").

[72] *See, e.g.*, MODEL BUS. CORP. ACT § 1.40(6) (AM. BAR ASS'N BUS. L. SECTION 2016).

[73] *See* DEL. CODE ANN. tit. 8, § 154 (2016).

[74] *See, e.g.*, Klang v. Smith's Food & Drug Ctrs., Inc., 702 A.2d 150, 155 (Del. 1997).

[75] *Id.* at 150.

[76] *Id.* at 152.

[77] *Id.*

[78] *Klang*, 702 A.2d at 152

Corporate directors in *Klang* authorized a share repurchase in connection with an acquisitive reorganization.[79] Plaintiffs' complaint alleged that the repurchase violated the impairment of capital test.[80] They claimed defendants miscalculated the available funds when utilizing the impairment of capital test.[81]

The corporation at issue, Smith's Food and Drug Centers, Inc. ("SFD"), operated a chain of supermarkets controlled by its CEO Jeffrey Smith and his family, who together held 62.1% of the voting stock of SFD.[82] In 1996, SFD was to merge with a subsidiary of the Yucaipa Companies ("Yucaipa").[83] The acquisition plan also included a recapitalization, which involved assuming new debt, repaying all old debts, and repurchasing SFD stock from its shareholders.[84] As part of the repurchase plan, SFD agreed to buy back 3 million shares of preferred stock from Smith and his family.[85]

The Board of Directors of SFD retained services of Houlihan Lokey Howard & Zukin ("Houlihan"), an investment firm, to ensure that the transactions at issue would not violate the impairment of capital test.[86] Relying on Houlihan's opinion, directors passed the resolution declaring that SFD had sufficient surplus for the repurchase.[87] The transaction then proceeded after the approval of SFD stockholders.[88]

Plaintiffs, the holders of SFD common stock, filed a complaint, alleging that the repurchase violated the impairment of capital test and arguing that on the face of SFD's balance sheet SFD's liabilities exceeded its assets.[89] They asserted that the balance sheet was "conclusive evidence" for purposes of the impairment of capital test.[90] The balance sheet prepared by the SFD board shortly before the repurchase showed that the transaction would exceed SFD's surplus, resulting in a deficit of more than $100 million.[91]

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[79] *Id.* Repurchases in Delaware must pass the impairment of capital test under DEL. CODE ANN. tit. 8, § 160 (2019).
[80] *Klang*, 702 A.2d at 153.
[81] *Id.*
[82] *Id.* at 152.
[83] *Id.*
[84] *Klang*, 702 A.2d at 152.
[85] *Id.*
[86] *Id.* at 152–53.
[87] *Id.* at 153.
[88] *Klang*, 702 A.2d at 153.
[89] *Id.* at 154.
[90] *Id.*
[91] *Id.*

The Court explained the standard for authorizing repurchases: the repurchase is not permitted if it causes an impairment of the corporation's capital.[92] The capital is impaired in instances when funds used in the distribution exceed surplus, which is defined as the excess of corporate net assets over legal capital, or par value of the corporation's issued stock.[93] The Court disagreed with the plaintiff that the corporate balance sheet should become controlling, recognizing that corporate books do not accurately reflect fair market value of assets and liabilities.[94] The Court explicitly authorized corporate directors to revalue assets and liabilities in calculating surplus.[95] In the alternative, plaintiff argued that even if the directors are permitted to go beyond the balance sheet to calculate surplus, the Houlihan analysis failed to account for the corporation's assets and liabilities.[96] Specifically, plaintiff alleged the Houlihan opinion neglected to account for certain current liabilities of the corporation.[97] The Delaware Supreme Court once again disagreed, adopting a liberal interpretation of the definition of net assets.[98] The Court clarified that nothing in the statute required any particular method of calculating surplus.[99] The analysis conducted by the Houlihan opinion complied with the statutory requirements.[100]

The Court then articulated a highly deferential standard for assessing propriety of distributions.[101] Courts must defer to the board's calculation of surplus "unless a plaintiff can show that the directors 'failed to 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.'"[102] According to the opinion, courts must not substitute their judgment for that of the directors in the absence of fraud or bad faith.[103] The burden is on the plaintiff to show that the board's methodology or analysis was "unreliable or that its determination of

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[92] *Klang*, 702 A.2d at 153.

[93] *Id.* (defining "surplus" pursuant to title 8, section 154 of the Delaware Code). DEL. CODE ANN. tit. 8, § 154 (2016).

[94] *Klang*, 702 A.2d at 154.

[95] *Id.*

[96] *Id.* at 154–55.

[97] *Id.* at 155.

[98] *See Klang*, 702 A.2d at 155.

[99] *Id.* (interpreting title 8, section 154 of the Delaware Code in concluding there is no required method of determining surplus); DEL. CODE ANN. tit. 8, § 154 (2016).

[100] *Klang*, 702 A.2d at 155; DEL. CODE ANN. tit. 8, § 160 (2019).

[101] *See Klang*, 702 A.2d at 155.

[102] *Id.* at 155–56 (quoting Morris v. Standard Gas & Elec. Co., 63 A.2d 577, 582 (Del. Ch. 1949)).

[103] *Id.* at 156 (citing *Morris*, 63 A.2d at 583).

surplus [was] so far off the mark as to constitute actual or constructive fraud."[104] Concluding that the SFD board nonetheless committed "a serious error" in its resolution authorizing the repurchase, the Court remarkably emphasized that being guilty of "sloppy work," and not following "good corporate practices" does not necessarily demonstrate a violation of the impairment of capital test.[105]

Thus, under current Delaware law, balance sheets are not conclusive evidence of surplus, and asset re-valuation is permitted.[106] Moreover, perfection is not required for asset valuation:

> Directors 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 of the surplus that is not so far off the mark as to constitute actual or constructive fraud.[107]

This flexible and deferential standard for authorizing dividends may make sense under the business judgment rule but, as will be demonstrated below, it does not comport with norms preventing fraudulent transfers.

Delaware's impairment of capital test provides no protection to creditors.[108] This lack of protection is potentially devastating to creditors who cannot protect themselves contractually by forbidding dividend payout while the debt is outstanding.

2. Modern Statutes

The MBCA significantly simplifies, and adds functionality to, the statutory rules. It eliminates the concepts of par value and legal capital, imposing instead two tests of solvency for distributions.[109] Under the so-called balance sheet insolvency test, a distribution is prohibited if, after

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[104] *Id.* at 156, 156 n.12 (noting that the Court interprets title 8, section 172 of the Delaware Code "to entitle boards to rely on experts such as Houlihan to determine compliance with 8 *Del.C.* § 160"); DEL. CODE ANN. tit. 8, §§ 160, 172 (2016).

[105] *Klang*, 702 A.2d at 156.

[106] *Id.* at 152.

[107] *Id.*

[108] *See* DEL. CODE ANN. tit. 8, § 154 (2016).

[109] *See id.* § 153; *see also* MODEL BUS. CORP. ACT § 6.40 (AM. BAR ASS'N BUS. L. SECTION 2016).

such a distribution, the corporation's assets would be less than its total liabilities and any liquidation preferences.[110] The second test, which must also be satisfied, is what is commonly referred to as an equitable insolvency, or a cash-flow, test: it focuses on whether the corporation will be able to pay debts as they become due in the usual course of business, after the proposed distribution.[111] Under the MBCA, the solvency tests are conjunctive, meaning the corporation must satisfy both the balance sheet test and the cash-flow test.[112] This approach recognizes that the original mathematical formula based entirely on the company's balance sheet did not take into account that many of the corporate assets may be illiquid.[113] For instance, if the corporation's sole assets are a production plant and some real estate on which the plant is located, even though the historical or current value of these assets may be substantial, these assets alone will not reflect the corporation's ability to meet its debt obligations.[114]

Thus, in the example above, the corporation whose assets exceed its liabilities by $4 million meets the balance-sheet test for distributions. But this mathematical calculation does not end the inquiry, and the fact that most of the corporate assets are illiquid when $1 million of its liabilities is debt due within one year would be crucial in the equitable insolvency determination.[115] This corporation is unlikely to be able to pay all its debts as they become due. Therefore, distributions will not be allowed.

The MBCA allows the board of directors, in determining the propriety of distributions, to rely on financial statements comporting with accounting practices, fair valuation, or other methods "reasonable in the circumstances."[116] The insolvency determination for lawfulness of distributions is not identical to the tests applied in bankruptcy or under state fraudulent transfer laws.[117]

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[110] MODEL BUS. CORP. ACT § 6.40(c)(2) (AM. BAR ASS'N BUS. L. SECTION 2016). This test is consistent with the Bankruptcy Code's definition of insolvency. *See* 11 U.S.C. § 101(32) (2012).

[111] *See* MODEL BUS. CORP. ACT § 6.40(c)(1) (AM. BAR ASS'N BUS. L. SECTION 2016).

[112] *See id.* § 6.40(c).

[113] *See id.* § 6.40 cmt. 1.

[114] *See id.* § 6.40 cmt. 1.

[115] *See* MODEL BUS. CORP. ACT § 6.40 cmt. 1 (AM. BAR ASS'N BUS. L. SECTION 2016).

[116] *Id.* § 6.40(d).

[117] 11 FLETCHER CYC. CORP. § 5329.10 (2018); *see also* MODEL BUS. CORP. ACT § 6.40 cmt. 4 (AM. BAR ASS'N BUS. L. SECTION 2016).

C. *Liability of Directors for Unlawful Dividends*

Corporate-law statutes impose liability on directors who unlawfully authorize dividends. In Delaware, directors who comply with the impairment of capital test enjoy the benefit of the business judgment presumption and their motives for declaring dividends are "immaterial," unless a plaintiff demonstrates that "the dividend payments resulted from improper motives and amounted to waste."[118] Directors who willfully or negligently violate statutory restrictions on distributions are jointly and severally liable.[119] Directors remain liable for the full amount of unlawful distributions to the corporation and to its creditors for six years after the unlawful dividend.[120] Those board members who did not vote for the unlawful dividend may be exonerated from liability if they were absent at the time the dividends were authorized or if their dissent from the authorization was properly documented.[121]

A Delaware corporation's director who is held liable is entitled to contribution from the other directors that authorized the unlawful distribution.[122] Additionally, directors who are held liable for unlawful distributions are entitled to subrogation to the rights of the corporation against stockholders that received unlawful distributions.[123] The claim against stockholders can be asserted only if the stockholders received the distribution with knowledge of its unlawful nature.[124] Though section 102(b)(7) of the Delaware General Corporations Law permits a corporation in its corporate charter to exculpate directors for any liability for damages, exculpation is explicitly disallowed for authorizing unlawful dividends.[125]

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[118] Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971).
[119] DEL. CODE ANN. tit. 8, § 174(a) (2016).
[120] *Id.*
[121] *Id.*
[122] *Id.* § 174(b).
[123] DEL. CODE ANN. tit. 8, § 174(c) (2016).
[124] *See id.*; *see also* EBS Litig. LLC v. Barclays Glob. Inv'rs, N.A., 304 F.3d 302, 307 (3d Cir. 2002) (suggesting that even if the shareholders are not innocent recipients of the dividend, a joint tortfeasor relationship may arise, with the shareholders as recipients and the directors as those who authorized unlawful dividends, providing a basis for contribution claims).
[125] *See In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 286 (Del. Ch. 2003) (quoting DEL. CODE ANN. tit. 8, § 102(b)(7) (2016)).

The MBCA similarly imposes liability on directors who authorize unlawful distributions.[126] Directors who are held liable are entitled to contribution from other directors and to recoupment from shareholders who knowingly accepted unlawful distributions.[127] Director liability is prohibited unless the lawsuit is commenced within two years after the distribution takes effect.[128] A typical dividend involves distributing to the shareholders some of the profits generated by corporate operations.[129] Another possible source for a distribution is borrowed funds.[130]

III. INHERENT RISKS OF DEBT-FUNDED DIVIDENDS

In recent years, many investors and corporations have benefitted from low interest rates by leveraging.[131] The leverage effect of debt has the potential of increasing gains of stockholders, while also magnifing losses, which are mostly born by creditors when a company is highly leveraged.[132] If an investment funded by debt is an imprudent one, the negative effects on the corporation's long-term prospects can be profound. Saddled with large debt payments, a corporation may become insolvent, giving rise to fraudulent transfer actions by the creditors.[133]

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[126] MODEL BUS. CORP. ACT § 8.32(a) (AM. BAR ASS'N BUS. L. SECTION 2016).

[127] *Id.* § 8.32(b).

[128] *Id.* § 8.32(c).

[129] Coryanne Hicks, *The Ultimate Guide to Dividend Stocks*, U.S. NEWS & WORLD REP. (Mar. 6, 2018, 9:00 AM), https://money.usnews.com/investing/investing-101/articles/what-are-dividends-and-how-do-they-work.

[130] *See* NEGOTIATED ACQUISITIONS OF COMPANIES SUBSIDIARIES AND DIVISIONS § 20.07, at 1.

[131] *See generally* Akin Oyedele, *Here's How the Fed Sets Interest Rates and Why it Matters*, BUS. INSIDER (Jul. 31, 2019, 2:57 PM), https://www.businessinsider.com/how-the-fed-raises-interest-rates-2017-12 (explaining how the Federal Reserve maintained low interest rates after the Great Recession, which kept the cost of borrowed funds lower to promote economic activity).

[132] *See* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 333–34 (1976) ("We don't find many large firms financed almost entirely with debt type claims (i.e., non-residual claims) because of the effect such a financial structure would have on the owner-manager's behavior. Potential creditors will not loan $100,000,000 to a firm in which the entrepreneur has an investment of $10,000. With that financial structure the owner-manager will have a strong incentive to engage in activities (investments) which promise very high payoffs if successful even if they have a very low probability of success. If they turn out well, he captures most of the gains, if they turn out badly, the creditors bear most of the costs."), *reprinted in* WILLIAM J. CARNEY, CORPORATE FINANCE 245 (Robert C. Clark et al. eds., 3d ed. 2015).

[133] *See* Mellon Bank, N.A. v. Metro Commc'ns, Inc., 945 F.2d 635, 645–46 (3d Cir. 1991), *cert. denied*, 503 U.S. 937 (1992) (providing a discussion of overleveraging in the context of a leveraged buyout: "The level of risk facing the newly structured corporation rises significantly due to the increased debt to equity ratio. This added risk is borne primarily by the unsecured creditors, those who will most likely not be paid in the event of bankruptcy.").

In some instances, borrowed funds are not invested by the borrower but rather paid out to the shareholders.[134] In one type of a leveraged recapitalization, known as a dividend recapitalization ("recap"), a company changes its capital structure by using debt to pay a special dividend to its stockholders.[135] These distributions are commonly referred to as debt-funded, or debt-financed, dividends.[136] Dividend recaps can be financed with a bank loan or by issuing bonds.[137] Many of the recent instances of debt-funded payouts were declared by corporate boards under pressure from PE funds.[138] By the end of the third quarter of 2017, special dividends paid to private equity firms accounted for a stunning $15.31 billion.[139] This number surpassed a striking $30 billion by November for the 2018 calendar year.[140]

Private equity funds may influence the board to pay out a dividend to realize some return on their investment without selling stock at low prices.[141] Often, private equity investors are the only stakeholders to benefit from these dividends: they hold preferred stock, and the debt-funded dividends can be limited to that class of stock only.[142] A dividend recapitalization may be the favored method of realizing a cash return on a PE investment for several reasons. Selling the company at depressed prices fails to maximize the return for PE investors.[143] They may wish to hold on to their stake in the company if they anticipate a potential turn-around

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[134] NEGOTIATED ACQUISITIONS OF COMPANIES SUBSIDIARIES AND DIVISIONS, *supra* note 130.

[135] A leveraged recapitalization can also be accomplished through other methods, such as a merger or a reclassification. *See id.*

[136] *See* T.J. Hope, *The Comeback of the Dividend Recap*, STOUT (last visited Sept. 15, 2019), https://www.stout.com/en/insights/article/comeback-dividend-recap/; *see also* Deborah Levine, *Some Dividends Come at Bondholders' Expense*, MKT. WATCH (Dec. 5, 2012, 6:00 AM), https://www.marketwatch.com/story/some-dividends-come-at-bondholders-expense-2012-12-05.

[137] NEGOTIATED ACQUISITIONS OF COMPANIES SUBSIDIARIES AND DIVISIONS, *supra* note 130 (mentioning how leveraged recapitalizations can be effectuated from the proceeds of borrowing or using debt securities).

[138] *See* Scigliuzzo, *supra* note 15; *see also* Ryan Dezember & Matt Wirz, *Private-Equity Payout Debt Surges*, WALL ST. J. (Aug. 6, 2013, 2:17 PM), https://www.wsj.com/articles/SB10001424127887323420604578650350584438488 (providing multiple examples of debt-funded payouts).

[139] *See* Cross, *supra* note 14.

[140] Scigliuzzo, *supra* note 15.

[141] Cross, *supra* note 14; Dezember & Wirz, *supra* note 138.

[142] *See Dividend Recapitalizations: Cash Alternatives for Private Equity*, CLEAR RIDGE CAP. (last visited Sept. 15, 2019), http://www.clearridgecapital.com/articles/dividend-recapitalizations-cash-alternatives-for-private-equity/.

[143] *Id.*

in business growth.[144] Additionally, taking a payout in the form of a dividend permits PE funds to pull out their cash investment, yet preserve the same ownership position.[145] Other more traditional exit strategies for PE funds, such as a public sale in an initial public offering ("IPO"), may not always be a viable alternative in a market where many IPOs have proven quite risky.[146] Most importantly, debt financing has been relatively cheap with current low interest rates, making borrowing an attractive option.[147]

Several recent instances of such payouts are notable. For example, in 2015, Apollo Global Management and Metropoulos & Company convinced the management of Hostess Brands to borrow approximately $1.3 billion and pay out $900 million dividends to the shareholders.[148] Another private equity group, SK Capital, invested money in a nylon manufacturer, which then borrowed $1 billion to pay out $922 million in dividends.[149] SK Capital multiplied its original investment of $50 million by 18-fold in just over a year.[150] In the fourth quarter of 2012, Costco issued $3.5 billion in debt mostly to fund a dividend.[151]

Another example is a PE fund payout in connection with the 2017 acquisition of a drug testing company, Parexel International ("Parexel"), by the private equity firm Pamplona Capital Management ("Pamplona Capital").[152] Pamplona Capital opened a line of credit, securing it with the unpaid health bills of Parexel Customers.[153] Pamplona Capital then used the borrowed funds to pay itself a $290-million dividend.[154] This harmed

[144] *Id.*
[145] *Id.*
[146] *See* Dawn Lim & Laura Cooper, *Private-Equity Firms Rethink Their Short-Term Focus; Some Look to Stay Invested in Companies for Unlimited Periods*, WALL ST. J. (June 19, 2018, 10:27 PM), https://www.wsj.com/articles/private-equity-firms-rethink-their-short-term-focus-1529460000.
[147] *See* Dasha Afanasieva & Lina Saigol, *Cheap Debt Allows Private Equity Firms to Reap More Dividends*, REUTERS (June 20, 2017, 6:31 AM), https://www.reuters.com/article/privateequity-dividends/cheap-debt-allows-private-equity-firms-to-reap-more-dividends-idUSL8N1J41JK.
[148] Michael Corkery & Ben Protess, *How the Twinkie Made the Superrich Even Richer*, N.Y. TIMES (Dec. 10, 2016), https://www.nytimes.com/2016/12/10/business/dealbook/how-the-twinkie-made-the-super-rich-even-richer.html?_r=0.
[149] Julie Creswell & Peter Lattman, *Private Equity Thrives Again, But Dark Shadows Loom*, N.Y. TIMES (Sept. 29, 2010), https://query.nytimes.com/gst/fullpage.html?res=9F0DE1D91438F93AA1575AC0A9669D8B63.
[150] *Id.*
[151] Levine, *supra* note 136.
[152] Scigliuzzo, *supra* note 15.
[153] *Id.*
[154] See *id.*

not only the company, but the investors who had already lent about $3 billion to the company.[155] In September of 2018, Moody's revised its rating of Parexel from stable to negative.[156] It is expected that the company's debt levels are now 7.5 or 8 times future earnings.[157]

The benefits of a debt-funded dividend to shareholder-investors are clear; and yet from the perspective of the company, its creditors, and other stakeholders, there are significant risks associated with taking on new debt to siphon cash to the shareholders. Stripping cash from the company increases risks of default or even bankruptcy. A dividend ties up resources that would otherwise be available for reinvestment into the company's future growth.[158] A higher debt load reduces the company's chances of weathering a general downturn in the economy.[159] Future interest payments on the new debt, even at a time of low interest rates, will drain the company's income.[160] When the debt matures, repayment of the principal will have a significant impact on cash flows as well.[161]

Moody's Investors Service usually downgrades companies after debt-funded dividends are paid, recognizing the negative impact on a company's financial performance.[162] For example, Moody's added Give and Go Prepared Foods Corp. to its distressed list due to dividends paid out by a private equity firm.[163] This Canadian maker of baked goods issued to its owner, a Boston private equity firm Thomas H. Lee Partners, a debt-financed dividend.[164] After the dividend was paid, Moody's dropped the company's ratings seven levels below investment grade because of its lack of free cash flow.[165]

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[155] *Id.*

[156] Scigliuzzo, *supra* note 15.

[157] *Id.*

[158] *See* Milken, *supra* note 4 (discussing some of the world's largest companies that bought back their stock with debt before the recession and noting that "[w]ithout stock buybacks, many such companies would have little debt and would have greater flexibility during this period of increased credit constraints. In other words, their current financial problems are self-imposed. Instead of entering the recession with adequate liquidity and less debt with long maturities, they had the wrong capital structure for the time.").

[159] *See* Jose Gabilondo, *Leveraged Liquidity: Bear Raids and Junk Loans in the New Credit Market*, 34 IOWA J. CORP. L. 447, 451 (2009).

[160] *Id.* at 454.

[161] *Id.* at 455.

[162] Idzelis, *supra* note 18.

[163] *Id.*

[164] *Moody's Downgrades Give and Go's CFR to Caa1; Outlook Now Stable*, MOODY'S INV. SERV. (Jun. 12, 2018), https://www.moodys.com/research/Moodys-downgrades-Give-Gos-CFR-to-Caa1-outlook-now-stable--PR_385071.

[165] *Id.*

Despite these inherent risks, at the time a dividend is declared the board of directors may satisfy corporate-law restrictions on distributions, which demonstrates the inadequacy of these restrictions. The decision to pay a dividend enjoys the protection of the business judgment rule.[166] Debt-funded dividends are justified by the desire to access cheap debt and to reward the company's shareholders.[167] Financial projections usually underscore the company's ability to meet its debt service obligations.[168] Some more mature companies that regularly pay dividends may borrow funds during financially difficult times to meet their investor expectations. For instance, Chevron has recently had to borrow the full $2 billion for each quarterly dividend that its investors have come to expect.[169]

Ultimately, some of the entities saddled with large amounts of debt have filed or will file for bankruptcy.[170] For example, the Simmons Bedding Company was forced to consider bankruptcy after it paid out hundreds of millions of dollars to its investor, Thomas H. Lee Partners of Boston, as a special dividend.[171] Simmons was left with a debt burden of $1.3 billion.[172] A large amount of the retailers that filed for bankruptcy within the past few years carried debt loads remaining from leveraged buyouts by private equity firms.[173] Analysis of M&A data by PitchBook and Debtwire reveals that 19 major retailers, including Payless, filed for Chapter 11 after being acquired by private equity firms.[174] Private-equity-owned retailers, like Toys R Us and Gymboree also filed for bankruptcy, revealing some of the associated risks.[175]

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[166] *See* Wabash Ry. Co. v. Barclay, 280 U.S. 197, 203–04 (1930) ("When a man buys stock instead of bonds he takes a greater risk in the business. No one suggests that he has a right to dividends if there are no net earnings. But the investment presupposes that the business is to go on, and therefore even if there are net earnings, the holder of stock, preferred as well as common, is entitled to have a dividend declared only out of such part of them as can be applied to dividends consistently with a wise administration of a going concern.").

[167] *See Moody's Downgrades Give and Go's CFR to Caa1; Outlook Now Stable*, *supra* note 164.

[168] *See* Gabilondo, *supra* note 159, at 455.

[169] John S. Tobey, *Is Chevron's Debt-Funded 4.5% Yield Really Worth 70x P/E, 300% Payout?*, FORBES (Mar. 31, 2016, 9:00 AM), https://www.forbes.com/sites/johntobey/2016/03/31/is-chevrons-debt-funded-4-5-yield-really-worth-70x-pe-300-payout/#3e546f386bfc.

[170] *See* Ben Unglesbee & Nicole Ault, *Is the Road to Bankruptcy Paved by Private Equity?*, RETAIL DIVE (Nov. 9, 2018), https://www.retaildive.com/news/the-road-to-bankruptcy/540617/ (noting that more than 15% of retailers owned by PE funds have filed for bankruptcy over the past 15 years).

[171] Julie Creswell, *Profits for Buyout Firms as Company Debt Soared*, N.Y. TIMES (Oct. 4, 2009), http://www.nytimes.com/2009/10/05/business/economy/05simmons.html.

[172] *See* Unglesbee & Ault, *supra* note 170.

[173] *Id.*

[174] *Id.*

[175] Carroll & Yozzo, *supra* note 16.

While in bankruptcy, the debt-funded dividend payouts may be recovered from shareholders by creditors as fraudulent transfers.[176] Thus, dividends that easily meet the state-law dividend restrictions may be problematic under the insolvency standards of fraudulent transfer laws.[177]

IV. FRAUDULENT TRANSFER AVOIDANCE OF DIVIDENDS

A. *Fraudulent Transfer Laws in General*

Fraudulent transfer laws can be traced back to the Statute of 13 Elizabeth that was promulgated by the English Parliament as the Fraudulent Conveyance Act 1571.[178] The act allowed creditors to avoid, or undo, transfers made by the debtor with actual intent to defraud a creditor.[179] The Statute of 13 Elizabeth served as the main source of American fraudulent transfer laws, specifically the Uniform Fraudulent Conveyance Act ("UFCA"), or the first uniform act put together by the Commission on Uniform State Laws.[180]

Today, fraudulent transfer avoidance is codified in the federal Bankruptcy Code and under state law.[181] Fraudulent transfer statutes permit creditors of insolvent debtors to avoid transactions that were either actually or constructively fraudulent.[182] For example, section 548(a)(1)(A) of the bankruptcy code allows the trustee to avoid transfers made "with actual intent to hinder, delay, or defraud."[183] Proof of actual fraud is difficult and requires demonstration of the transferor's subjective state of mind.[184] Because of these difficulties, creditors often point to

[176] 5 COLLIER ON BANKRUPTCY ¶ 548.03 (16th ed. 2018).

[177] Nicholas F. Kajon, *Dividend Recaps: Why Some of Today's Private Equity Deals May Become Tomorrow's Fraudulent Conveyances*, STEVENS & LEE (Jan. 20, 2007), https://www.stevenslee.com/dividend-recaps-why-some-of-todays-private-equity-deals-may-become-tomorrows-fraudulent-conveyances/.

[178] *See generally* 5 COLLIER ON BANKRUPTCY ¶ 548.01 (16th ed. 2018) (briefly discussing the evolution of fraudulent transfer laws).

[179] *Id.*

[180] James Angell McLaughlin, *Application of the Uniform Fraudulent Conveyance Act*, 46 HARV. L. REV. 404, 405 (1933) ("The use of the words of art, 'conveyance ... with intent ... to hinder, delay or defraud ... creditors', gives the cue that this is a modernized Statute of Elizabeth and nothing else.").

[181] 5 COLLIER ON BANKRUPTCY ¶ 548.01 (16th ed. 2018).

[182] *Id.*

[183] 11 U.S.C. § 548(a)(1)(A) (2012).

[184] 5 COLLIER ON BANKRUPTCY ¶ 548.04 (16th ed. 2018).

circumstantial evidence of actual fraud by resorting to the judicially developed "badges of fraud."[185]

The so-called constructively fraudulent transfers are also avoidable under the federal Bankruptcy Code. Section 548(a)(1)(B) requires a two-part showing: the transfer must have been for "less than a reasonably equivalent value" and must have been made while the debtor was already insolvent or must have made the debtor insolvent.[186] The statute provides three different ways to demonstrate the debtor's impaired financial condition: the debtor's liabilities were in excess of its assets[187]; debtor was left with "an unreasonably small capital"[188]; debtor incurred debts beyond its ability to pay.[189] Showing of insolvency is not necessary when the transfer for less than reasonably equivalent value is made for the benefit of an insider outside of the ordinary course of business and pursuant to an employment agreement.[190]

The Bankruptcy Code also permits the trustee to undo transfers that could be avoided by actual unsecured creditor pursuant to applicable non-bankruptcy law.[191] Section 544(b) invokes state law on fraudulent transfer avoidance.[192] Despite the necessity to demonstrate the existence of an actual unsecured creditor that could undo the transfer outside of bankruptcy, avoidance under section 544(b) may be advantageous due to sometimes longer clawback periods.[193] For instance, Delaware law permits avoidance of constructively fraudulent transfers "within [four] years after the transfer was made or the obligation was incurred," whereas section 548 of the Bankruptcy Code limits clawbacks to two years.[194]

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[185] *Id.* ¶ 548.05; *see, e.g.*, *In re* Kaiser, 722 F.2d 1574, 1582–83 (2d Cir. 1983) (listing the following circumstances as judicially identified "badges of fraud": "(1) the lack or inadequacy of consideration; (2) the family, friendship or close associate relationship between the parties; (3) the retention of possession, benefit or use of the property in question; (4) the financial condition of the party sought to be charged both before and after the transaction in question; (5) the existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; and (6) the general chronology of the events and transactions under inquiry.").

[186] 11 U.S.C. § 548(a)(1)(B)(i)-(ii) (2012).

[187] *Id.* § 548(a)(1)(B)(ii)(I).

[188] *Id.* § 548(a)(1)(B)(ii)(II).

[189] *Id.* § 548(a)(1)(B)(ii)(III).

[190] 11 U.S.C. §§ 548(a)(1)(B)(i), (ii)(IV) (2012).

[191] *Id.* § 544(a).

[192] *Id.* § 544(b)(1).

[193] *Id.*

[194] DEL. CODE ANN. tit. 6, § 1309(1) (2016); 11 U.S.C. § 548(a)(1) (2012).

Fraudulent transfer avoidance under state law is based on one of three separate uniform acts.[195] Though statutes may utilize different terminology, and clawback periods vary from state to state, the substance of state law on fraudulent transfer avoidance is mostly the same.[196] The first uniform set of laws—the UFCA—was initially proposed by the Uniform Law Commission in 1916 and is still the governing law in a small minority of states.[197] The UFCA was initially adopted in 1919 by eight states, with many more to soon follow in their footsteps.[198] For example, under New York's version of the Uniform Fraudulent Conveyance Act,[199] a conveyance is considered "fraudulent as to creditors without regard to [] actual intent" when an insolvent person makes such a conveyance "without a fair consideration."[200] The statute's definition of insolvency focuses on the transferor's inability to pay debts as they become due.[201] The element of fair consideration is satisfied when in exchange for the conveyed property, "as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied, or [when the conveyed property] is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property."[202]

The UFCA's successor, still in effect in the majority of states today, is the Uniform Fraudulent Transfer Act ("UFTA").[203] This Act revised the UFCA to conform to the Bankruptcy Reform Act of 1978 and follows the terminology of section 548.[204] Delaware's Uniform Fraudulent Transfer Act, for example, tracks the UFTA.[205] Currently, a total of thirty-seven states have legislation based on the UFTA.[206] Even though the terminology in the new Act changed to be consistent with the

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[195] 11 U.S.C. § 544(b)(1) (2012).

[196] 5 COLLIER ON BANKRUPTCY ¶ 548.01 (16th ed. 2018).

[197] *Id.*

[198] McLaughlin, *supra* note 180, at 404.

[199] As of February 2019, the New York legislature proposed and adopted a complete repeal of its Debtor Creditor Law. The proposal will replace the current version based on the Uniform Fraudulent Conveyance Act with the Uniform Voidable Transactions Act. *See* 2019 N.Y. Laws 5622.

[200] N.Y. DEBT. & CRED. LAW § 273 (McKinney).

[201] *Id.* § 271.

[202] *Id.* § 272.

[203] 1 COLLIER ON BANKRUPTCY ¶ 548.01B (16th ed. 2019).

[204] Gary A. Foster & Eric C. Boughman, *The Uniform Voidable Transactions Act: An Overview of Refinements to the Uniform Fraudulent Transfer Act*, 29 PROB. & PROP. 51, 51 (2015).

[205] DEL. CODE ANN. tit. 6, § 1301(1)-(7) (2016).

[206] 1 COLLIER ON BANKRUPTCY ¶ 548.01B (16th ed. 2019).

Bankruptcy Code, courts interpreted UFTA substantively the same as the older version of the statute in UFCA.[207]

Most recently, the Uniform Law Commission adopted the Uniform Voidable Transactions Act ("UVTA") to replace the UFTA with the goal of providing consistency in judicial interpretations and codifying a rule regarding choice of law.[208] Additionally, the UVTA seeks to comport with the Uniform Commercial Code ("UCC") and the Bankruptcy Code.[209] Significantly, the term "fraudulent" is replaced with a clearer word "voidable" to reconcile some inconsistent usage under the UFTA.[210] Even though the change in terminology is not intended to change the substance of the law, the replacement clarifies that no state of mind is required to prove actual fraud and eliminates the oxymoronic phrase "constructive fraud."[211] Nine states have so far adopted the UVTA and a few more have pending legislation.[212]

After the elements of avoidance are met, the trustee in bankruptcy may recover the property from any transferee.[213]

B. *Dividend Payments as Fraudulent Transfers*

A dividend payment to shareholders is a quintessential example of a constructively fraudulent transfer if made when the corporation is insolvent or becomes insolvent after the transfer.[214] There is no doubt that

[207] *See, e.g.*, *In re* TC Liquidations LLC, 463 B.R. 257, 267 (Bankr. E.D.N.Y. 2011) ("The terms 'reasonably equivalent value' in section 548(a)(1)(B) and the terms 'fair consideration' in the [New York's version of the UFCA] have the 'same fundamental meaning' and are interpreted similarly by the courts.") (quoting *In re* Churchill Mortg. Inv. Corp., 256 B.R. 664, 677 (Bankr. S.D.N.Y. 2000); *In re* Duke & Benedict, Inc., 265 B.R. 524, 530 n.7 (Bankr. S.D.N.Y. 2001)).

[208] Foster & Boughman, *supra* note 204, at 51.

[209] *Id.*

[210] *Id.*

[211] *Id.* at 51-52 (citing UVTA §§ 14 cmt. 1, 4 cmt. 10).

[212] 1 COLLIER ON BANKRUPTCY ¶ 548.01C (16th ed. 2019) (listing California, Georgia, Idaho, Iowa, Kentucky, Minnesota, New Mexico, North Carolina, and North Dakota as states that have adopted UVTA).

[213] 11 U.S.C. § 550 (2012); 5 COLLIER ON BANKRUPTCY ¶ 548.10 (6th ed. 2019).

[214] COX & HAZEN, *supra* note 48, § 20:26; *see, e.g.*, *In re* Appleseed's Intermediate Holdings, LLC, 470 B.R. 289, 304 (D. Del. 2012) (denying a motion to dismiss claims to avoid dividends that PE funds forced the debtor and its affiliates to pay out of borrowed funds); *In re* TC Liquidations LLC, 463 B.R. 257, 279-80 (Bankr. E.D.N.Y. 2011) (avoiding as fraudulent transfers some of the dividends a Chapter 7 debtor paid to its four insider shareholders); *In re* Trace Int'l Holdings, Inc., 289 B.R. 548, 560-61 (Bankr. S.D.N.Y. 2003) (denying a motion to dismiss claims to avoid as constructively fraudulent transfers payments of a dividend by an insolvent corporation to preferred shareholders, even though such payments were pursuant to a prior agreement).

a typical dividend does not require shareholders to give any reasonably equivalent value to the corporation, so the real issue is the evaluation of insolvency.[215]

For example, *Hyde Properties v. McCoy*, which involved allegations regarding a stock redemption, was an avoidable fraudulent conveyance under Tennessee law (based on UFCA).[216] A struggling company, International House of Pancakes of Tennessee, Inc. ("IHPT"), redeemed the interest of one of its three co-owners, defendant Clyde McCoy ("McCoy").[217] In exchange for his shares, McCoy received two promissory notes that the company received when it sold some real estate to plaintiff Hyde Properties.[218] The redemption took place amid a liquidity crisis that caused IHPT's delinquency on various obligations to creditors, specifically both federal and state taxes.[219] Shortly after the sale to Hyde Properties, the IRS filed a notice of tax lien and levied upon Hyde Properties.[220]The government alleged that the transfer of promissory notes to McCoy was a fraudulent conveyance, with McCoy arguing in response that the redemption of his shares was a lawful transaction.[221]

The Sixth Circuit affirmed the district court's decision to avoid the redemption to McCoy.[222]The analysis hinged on whether the alleged insolvency of IHTP was apparent at the time of the redemption.[223] The district court concluded that the corporation was insolvent despite the balance sheet and the testimony offered into evidence defendant McCoy.[224] The district court's finding of insolvency was based on its determination that the balance sheet was misleading, because it understated depreciation and tax liabilities and overstated the value of some assets.[225] Additionally, the exchange of McCoy's worthless shares for Hyde Properties' promissory notes was, under Tennessee law, a conveyance without fair consideration and thus fraudulent.[226]

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[215] Peter Spero, *Fraudulent Transfers, Prebankruptcy Planning and Exemptions*, FR-TRNSFRS § 2:37 (2018).

[216] Hyde Props. v. McCoy, 507 F.2d 301, 307 (6th Cir. 1974).

[217] *Id.* at 303–04.

[218] *Id.*

[219] *Id.* at 303.

[220] *Hyde*, 507 F.2d at 304.

[221] *Id.*

[222] *See id.* at 307–08 (finding that "[t]he district court was correct in setting aside the conveyance and in awarding the fund to the United States").

[223] *Id.* at 306.

[224] *Hyde*, 507 F.2d at 307.

[225] *Id.*

[226] *Id.*

In *Boyer v. Crown Stock Distribution Inc.*, Judge Posner, as part of a Seventh Circuit appeals panel, held that a dividend paid out to a company's shareholders around the same time as its leveraged buyout was avoidable as a fraudulent transfer.[227] During the Chapter 7 bankruptcy of Crown Unlimited Machine, Inc. ("CUMI"), the trustee sought to recover certain funds from the corporation and its shareholders under section 544(b) and the applicable non-bankruptcy law, or Indiana Code section 32–18–2–14(2) (2017) (which mirrors the UFTA).[228] The debtor, CUMI, was formed as part of a leveraged buyout of Crown, a corporation in the business of designing and manufacturing of tube cutting and bending machinery.[229] In the buyout, the debtor paid $6 million for Crown, $3.1 million of which was cash borrowed from a bank and $2.9 million in the form of a promissory note.[230]

Prior to the acquisition, Crown had transferred approximately $600,000 to its shareholders in the form of a dividend.[231] The same shareholders received the distribution of the $3.1 million cash that Crown was paid by the debtor in a leveraged buyout.[232] After the debtor filed for bankruptcy, the Chapter 7 trustee brought a timely adversary proceeding to undo both the leveraged buyout and the dividend.[233] The bankruptcy judge concluded that the debtor did not receive reasonably equivalent value in exchange for its $6 million buyout payment in the LBO and that the LBO left the debtor with assets that were "unreasonably small in relation to the business."[234] With respect to the $600,000 dividend, bankruptcy judge held that it was off-limits for the trustee because it was properly paid to the shareholders of Crown out of the funds belonging to Crown.[235] The bankruptcy judge refused to collapse the transaction so as to treat the LBO as a sale by Crown's shareholders, rejecting the trustee's argument that the dividend should be part of the property of the estate.[236]

Concluding that this LBO "was *highly* likely to plunge the company into bankruptcy," Judge Posner emphasized that the LBO "left the firm with so few assets that it would have had to be extremely lucky to

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[227] Boyer v. Crown Stock Distribution, Inc., 587 F.3d 787, 787 (7th Cir. 2009).
[228] *Id.* at 790.
[229] *Id.*
[230] *Id.*
[231] *Boyer*, 587 F.3d at 790.
[232] *Id.* at 791.
[233] *Id.*
[234] *Id.*
[235] *Boyer*, 587 F.3d at 791.
[236] *Id.*

survive."[237] The court held that the dividend paid to Crown's shareholders was a fraudulent transfer, and not "a normal distribution of previously earned profits."[238] In support of its conclusion, the court pointed to several facts.[239] First, a closely held entity like Crown would normally distribute profits to its owners in the form of salaries to avoid double taxation of these profits.[240] Second, even though the trustee did not present evidence about Crown's ordinary dividend practices, the court presumed that at least four of Crown's shareholders were salaried because they served as officers or directors.[241] Finally, the $600,000 dividend accounted for half of Crown's 1999 profits, a distribution "unreasonably high given the cash needs of the business."[242] Draining Crown's cash "all unbeknownst to the corporation's present and future unsecured creditors" served as an indicator that this dividend was a part of a fraudulent transfer.[243]

C. *Debt-Funded Dividends as Fraudulent Transfers*

In instances where the dividend is funded with debt, the danger of insolvency is very high.[244] The borrowed funds, instead of being invested for cash-generating purposes, are paid out to the stockholders.[245] If the corporation is already showing signs of struggle, any assets on hand would be properly claimed by creditors, and using these assets to pay the stockholders violates the rules of priority of repayment of claims and interests.[246] These dividends are likely recoverable by creditors in an avoidance action.

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[237] *Id.* at 793 (emphasis in original).
[238] *Id.* at 796.
[239] *Boyer*, 587 F.3d at 795-96.
[240] *Id.* at 795.
[241] *Id.* at 795-96.
[242] *Id.* at 796.
[243] *Boyer*, 587 F.3d at 796.
[244] Jonathan M. Landers & Sandra A. Riemer, *A New Look at Fraudulent Transfer Liability in High Risk Transactions*, BUS. L. TODAY (Dec. 20, 2016), https://www.americanbar.org/groups/business_law/publications/blt/2016/12/01_landers/ (noting that, as a result of leveraged recapitalizations, the company's "debt is increased, usually significantly, resulting in greater leverage; potential cash flow and solvency issues; and, ultimately, a much larger risk of default, insolvency and liquidation").
[245] *Id.*
[246] *Id.*

V. A CASE FOR INCORPORATING FRAUDULENT TRANSFER STANDARDS INTO CORPORATE LAWS RESTRICTING DISTRIBUTIONS

Unfortunately, as demonstrated below, corporate-law standards for dividends do not accord with fraudulent transfer laws.[247] This inconsistency leads to anomalous and unjust results, shielding directors from liability in instances where dividends are recoverable by creditors from the often-innocent shareholder.

A. *Discrepancies in Corporate-Law Dividend Restrictions and Standards for Fraudulent Transfer Avoidance*

It is clear that some transfers of property to shareholders as dividends may be avoided under fraudulent transfer laws. This is especially true in the case of debt-funded dividends that are likely to precipitate insolvency. A trustee in bankruptcy or a creditor under state law can recover transferred property from the shareholders.[248] Avoidance is the remedy against shareholders as the ultimate transferees where the elements of a fraudulent transfer are met: the corporation must have received less than a reasonably equivalent value for the transfer that was made when the corporation was insolvent or that caused the corporation's insolvency.[249] Yet, recovery from directors under corporate statutes may not be possible, even if the transfer the directors authorized is found to be fraudulent.

1. Inconsistent Standards for Showing Insolvency

Fraudulent transfer laws permit recovery from shareholders upon a showing of current or resulting insolvency.[250] Under the Bankruptcy Code, insolvency is defined as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation."[251] In assessing balance-sheet insolvency, courts are neither bound by GAAP standards nor by the book value of the assets, focusing

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[247] *But see* MANNING & HANKS, *supra* note 50, at 69 ("The Uniform Fraudulent Transfer Act may be interpreted to produce the same result [as corporation laws], since it provides that a transfer made without receiving a reasonably equivalent value in exchange by a person who is rendered insolvent thereby is fraudulent as to creditors.").

[248] 11 U.S.C. §§ 548, 550 (2012).

[249] *Id.* § 548(a)(1)(B)(i), (ii)(I).

[250] *See generally* Glenda K. Harnad & Sonja Larsen, *Determining Insolvency for Businesses*, 37 AM. JUR. 2D FRAUDULENT CONVEYANCES AND TRANSFERS § 22, Westlaw (database updated Aug. 2019) (discussing an overview of ways that courts apply the different tests of insolvency).

[251] 11 U.S.C. § 101(32)(A) (2012).

instead on the totality of circumstances.[252] Fair value of the assets in this context will be assessed either as a going concern or in liquidation, depending on the debtor's condition at the time of the transfer.[253]

However, under section 548(a)(1)(B), the debtor's state of affairs can be alternatively assessed through other tests. In addition to the balance-sheet insolvency, transfers are avoidable if the debtor's business or transaction left the debtor with property that was "an unreasonably small capital."[254] Though the quoted language is not defined in the Code, cases focus on the debtor's ability to sustain its operations by generating profits.[255] Courts have also considered the debtor's access to credit as part of this inquiry.[256]

Another focus is on the debtor's cash flow: the debtor's inability to pay debts as they mature.[257] This test looks at the debtor's future prospects and takes into account the debtor's knowledge of its future liquidity issues.[258] Specifically, transfers become avoidable if "the debtor made the transfer or incurred an obligation contemporaneous with an intent or belief that subsequent creditors likely would not be paid as their claims matured."[259]

State fraudulent transfer laws employ a similar standard. In Delaware, insolvency as part of fraudulent transfer laws is based on the balance-sheet test (if the sum of liabilities exceeds the debtor's assets) or the cash-flow test (if the debtor is not paying debts as they become due).[260] An additional assessment permits recovery of transfers that left the debtor

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[252] *In re* EBC I, Inc., 380 B.R. 348, 358 (Bankr. D. Del. 2008), *aff'd*, 400 B.R. 13 (D. Del. 2009), *aff'd*, 382 F. App'x 135 (3d Cir. 2010).

[253] *In re* Am. Classic Voyages Co., 367 B.R. 500, 508 (Bankr. D. Del. 2007), *aff'd sub nom*. *In re* Am. Classic Voyages, Co., 384 B.R. 62 (D. Del. 2008) ("In determining a 'fair valuation' of the entity's assets, an initial decision to be made is whether to value the assets on a going concern basis or a liquidation basis.").

[254] *See* 11 U.S.C. § 548(a)(1)(B) (2012).

[255] Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1070 (3d Cir. 1992).

[256] *Id.* at 1073 ("[I]t was proper for the district court to consider availability of credit in determining whether [the debtor] was left with an unreasonably small capital.").

[257] 11 U.S.C. § 548(a)(1)(B) (2012). Another test permits recovery of transfers made "to or for the benefit of an insider." *Id.* § 548(a)(1)(B)(ii)(IV).

[258] Robert J. Stearn, Jr. & Cory D. Kandestin, *Delaware's Solvency Test: What Is It and Does It Make Sense? A Comparison of Solvency Tests Under the Bankruptcy Code and Delaware Law*, 36 DEL. J. CORP. L. 165, 173-74 (2011).

[259] *In re* WRT Energy Corp., 282 B.R. 343, 414-15 (Bankr. W.D. La. 2001).

[260] DEL. CODE ANN. tit. 6, § 1302 (2016).

with assets that were "unreasonably small in relation to the business or transaction."[261]

Corporate-law standard under the impairment of capital focuses on the meaningless concept of par value.[262] The flexible test of *Klang* accords much deference to directors in calculating surplus.[263] Even the more exacting standards under the MBCA protect directors from liability if they rely on expert opinions and in absence of fraud or illegality.[264] Corporate law thus makes holding the actual decision-makers accountable for the unlawful distribution a much harder task than recovery from shareholders— a result that is absurd and thus difficult to justify.

2. Differences in Remedies Under Fraudulent Transfer Laws and Corporate Statutes

Corporate-law statutes, while imposing restrictions on dividend payments, provide a remedy against the directors who authorized the dividend.[265] Generally, creditors (or the corporation) can recover from directors anything distributed in excess of the statutory limitations.[266] Recovery from the shareholders under corporate statutes is possible only in instances when shareholders received illegal distributions with knowledge.[267] On the other hand, under fraudulent transfer laws, recovery is from the shareholders as transferees.[268] Non-shareholder directors are not the proper defendants in fraudulent transfer actions.

At first glance, these two bodies of law seem to complement each other in allowing creditors to pursue both the shareholder transferees as

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[261] *Id.* § 1304; *see also* Harnad & Larsen, *supra* note 250 (providing an overview for how courts apply each one of the tests of insolvency).

[262] *See* DEL. CODE ANN. tit. 8, § 153 (2016).

[263] *See* Klang v. Smith's Food & Drug Ctrs., Inc., 702 A.2d 150, 152 (Del. 1997).

[264] *See* MODEL BUS. CORP. ACT § 6.40(d) (AM. BAR ASS'N BUS. L. SECTION 2016). *But see* James E. Tucker, *Director and Shareholder Liability for Massachusetts Corporations' Distributions to Shareholders: A Suggestion for Change in Standards of Director Liability*, 28 NEW ENG. L. REV. 1025, 1055 (1994) (noting that, in authorizing distributions, "directors may use the fraudulent conveyance law balance sheet and equity tests" and that they may incur liability for "a distribution from a corporation insolvent under either fraudulent conveyance law insolvency test").

[265] *See generally* COX & HAZEN, *supra* note 48, § 20:23 (providing an overview of the remedies available against directors).

[266] *But see* N.Y. BUS. CORP. LAW § 719 (McKinney 2019) (limiting director liability to any injury suffered by creditors or shareholders).

[267] COX & HAZEN, *supra* note 48, § 20:26.

[268] *Id.*

well as the directors who authorized the transfer.[269] What is problematic however is the discrepancy in the standards applicable to creditors' remedies against the directors and those against the shareholder recipients. Avoidance remains a viable remedy against shareholders for creditors even in instances when these shareholders have absolutely no knowledge of the transfer's illegality.[270] Yet, in some instances, dividends that qualify as fraudulent transfers may be able to pass state standards for distributions, absolving directors of liability.[271]

3. Inconsistent Statutes of Limitation and Clawback Periods

One difficulty arises due to inconsistent statutes of limitations under state corporate law and clawback periods in fraudulent transfer actions. Section 548 of the Bankruptcy Code allows for a two-year clawback period, while the strong-arm provision in section 544 incorporates state-law avoidance remedies with their respective statutes.[272] The clawback period under Delaware Uniform Fraudulent Transfer Act, for example, is four years.[273]

Actions against directors for unlawful distributions can be brought by the corporation or its creditors in the event of the corporation's dissolution or insolvency.[274] In a jurisdiction adopting the MBCA, an action against directors for unlawful distributions must be brought within two years after the distribution takes effect.[275] In Delaware, directors remain liable for unlawful distributions for six years after paying such dividends.[276]

Thus, timing of a potential lawsuit challenging the same transaction depends on the cause of action (fraudulent transfer avoidance vs. challenging the statutory lawfulness of the dividend) and will also vary from jurisdiction to jurisdiction. Uniformity in this area would prevent forum shopping, add predictability, and ensure that the same transaction can be challenged within one timeframe.

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[269] *See generally id.* (reviewing differences between remedies available to creditors under state corporate statutes for illegal dividends and under fraudulent transfer laws).

[270] DEL. CODE ANN. tit. 6, § 1309 (1996).

[271] *See* Tucker, *supra* note 213, at 1068 (advocating for an amendment of the Massachusetts corporations statute on distributions "so that directors are never liable for distributions if the directors, acting in good faith, with reasonable prudence, and as if disinterested (where they are interested) . . .").

[272] 11 U.S.C. §§ 544, 548 (2012).

[273] DEL. CODE ANN. tit. 6, § 1309 (1996).

[274] DEL. CODE ANN. tit. 8, § 174(a) (2016).

[275] MODEL BUS. CORP. ACT § 8.32(c) (AM. BAR ASS'N BUS. L. SECTION 2016).

[276] DEL. CODE ANN. tit. 8, § 174(a) (2016).

4. Inadequacy of Actions for Directors' Breach of Fiduciary Duties

In an instance where stockholders are subject to a clawback action and are forced to repay unlawful distributions, the stockholders can maintain a claim against corporate directors for a breach of their fiduciary duties.[277] For example, the Third Circuit applied Delaware law in *EBS Litigation LLC v. Barclays Global Investors, N.A.*, allowing shareholders to pursue a cause of action for breach of fiduciary duties against the directors.[278] Edison Brothers Stores, Inc. ("Edison"), following a unanimous resolution of its board of directors, distributed to Edison public shareholders the stock of Dave and Busters, Inc. ("D&B").[279] Following Edison's voluntary Chapter 11 petition, the stock distribution was held to be an avoidable transfer under sections 544(b) and 548(a) of the Bankruptcy Code.[280]

Defendant shareholders pursued a third-party complaint against the directors of Edison for breaching their fiduciary duties in declaring the unlawful stock dividend and in misrepresenting to the Edison shareholders the financial well-being of the company and the legitimacy of the dividend.[281] The same shareholders asserted a complaint against the directors of D&B for aiding and abetting the breaches of fiduciary duty.[282] Defendant directors alleged that the shareholders' claims were unfounded because these shareholders had to return the distributions for which they did not give any value.[283] On a motion to dismiss and without addressing the merits of these claims, the Third Circuit acknowledged the possibility that the directors could be liable if shareholders are held liable in the fraudulent transfer action.[284]

The liability of directors is not automatic, however. If directors in good conscience and relying on an expert's solvency opinion declare a dividend compliant with state law, the shareholders' remedy against the directors is severely limited.[285] Even though shareholders are entitled to

[277] *See* EBS Litig. LLC v. Barclays Glob. Inv'rs, N.A., 304 F.3d 302, 302-03 (3d Cir. 2002).
[278] *Id.*
[279] *Id.* at 304.
[280] *Id.* at 304-05.
[281] *EBS Litig.*, 304 F.3d at 304-05.
[282] *Id.* at 305.
[283] *Id.* at 307.
[284] *Id.*
[285] *See* DEL. CODE ANN. tit. 8, § 141(e) (2019).

sue for a breach of fiduciary duties, this remedy is inadequate for several reasons.

Authorizing a dividend later determined to be a fraudulent transfer may well be protected under the business judgment rule, unless the shareholder is able to assert fraud, self-dealing, inadequate process, or illegality.[286] Though a transfer for less than reasonably equivalent value resulting in corporate insolvency is technically considered "constructively fraudulent," avoidance actions do not require any showing of a state of mind, and in fact are not at all based on fraud.[287] Unless the dividend was paid to hinder, delay, or defraud creditors or for any other fraudulent purpose, a showing of constructive fraud in and of itself is unlikely to overcome the presumption of the business judgment rule.[288]

Directors may also be shielded from liability by exculpatory clauses that would prevent any damages recovery.[289] Exculpation is currently unavailable only when the directors issued a dividend that fails to satisfy state-law standards.[290] A breach of fiduciary duty of care, even if proven, would not subject directors to money-damages liability if the corporation's charter adopts an exculpatory clause.[291]

Finally, some fraudulent transfer statutes have longer clawback periods than the statute of limitations for an action that alleges a breach of fiduciary duties.[292] Shareholders would arguably have no standing to sue directors for damages unless and until they are forced to return the dividend for the benefit of the corporation's creditors. By then, the statute

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[286] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993), *decision modified on reargument*, 636 A.2d 956 (Del. 1994) ("The rule posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be attributed to any rational business purpose. . . . [A] shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty—good faith, loyalty or due care.") (emphasis in original) (internal quotation marks omitted).

[287] Harnad & Larsen, *supra* note 250, § 24 ("[F]raud is presumed if the debtor transfers property for less than adequate value and is thereby unable to meet his or her obligations.").

[288] *See Technicolor*, 634 A.2d at 361.

[289] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2019).

[290] *Id.* § 102(b)(7)(iii).

[291] *Id.* § 102(b)(7).

[292] *See, e.g.*, DEL. CODE ANN. tit. 10, § 8106 (2014) (imposing a three-year statute of limitations to actions for money damages); Laventhol, Krekstein, Horwath & Horwath v. Tuckman, 372 A.2d 168, 169-70 (Del. 1976) (noting that an action for a breach of fiduciary duty seeking money damages is legal in nature and subject to the statute of limitations, but denying the benefits of the statute of limitations to fiduciaries engaged in fraudulent self-dealing).

of limitations for breaches of fiduciary duties may have run out, thus precluding recovery.

B. *Reconciling the Discrepancy by Incorporating Fraudulent Transfer Laws as a Limitation on Corporate Distributions*

A hard look at a disturbing practice of debt-funded dividends reveals the need to reconcile state statutes imposing limitations on distributions with the standard that applies in fraudulent transfer actions. In addition to the current legal capital and insolvency limitations imposed by corporate law, statutes restricting dividends should specifically incorporate fraudulent transfer standards, namely dividends should be made unlawful if their distribution would violate fraudulent transfer laws.[293]

The most significant effect of incorporating fraudulent transfer laws into restrictions on distributions is adopting the same test of insolvency and imposing liability on directors for dividends that are fraudulent transfers. Today's fraudulent transfer laws limit remedies to recovery only from transferees, inadvertently shielding non-shareholder directors from any liability for flawed decision making.[294] One corporate transaction may give rise to several lawsuits, reaching often inconsistent results. Creditors can sue to recover the dividend from the shareholders.[295] Shareholders may file a derivative suit for a breach of fiduciary duties against the corporate directors.[296] Holding directors liable for unlawful dividends under the standard of fraudulent transfer laws would give creditors standing to sue not only the shareholders (as transferees of a fraudulent transfer) but also corporate directors (for damages to creditors resulting from a violation of corporate law).

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[293] *See generally* DEL. CODE ANN. tit. 6, § 1304 (2019) (fraudulent transfer can be shown by actual or constructive fraud using established indicators of fraud).

[294] *See* 11 U.S.C. § 550 (2016) ("[T]he trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from-- (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee.").

[295] *See, e.g.*, DEL. CODE ANN. tit. 8, § 174(a) (2016) ("[T]he directors . . . shall be jointly and severally liable . . . to its creditors in the event of its dissolution or insolvency, to the full amount of the dividend unlawfully paid, or to the full amount unlawfully paid for the purchase or redemption of the corporation's stock, with interest from the time such liability accrued.").

[296] *See, e.g.*, EBS Litig. LLC v. Barclays Glob. Inv'rs, N.A., 304 F.3d 302, 302 (3d Cir. 2002) (Third Circuit reversed dismissal, finding shareholders' breach of fiduciary duties claim was meritorious).

Imposing fraudulent transfer standards on dividend authorization would streamline any subsequent litigation. Currently, illegal dividends can be recovered by the corporation from the shareholders only if, at the time of the dividend, the shareholders knew of its illegality.[297] Yet, the corporation may pursue the same shareholders for the very same payments in a fraudulent transfer action in or out of bankruptcy. Additionally, if a creditor is permitted to recover a dividend payment as a fraudulent transfer from the recipient shareholder, a director that authorized this illegal dividend should also be liable. It is absurd to impose liability on an unknowing shareholder, yet allowing the directors to satisfy liberal standards of *Klang*.[298]

From a planning perspective, consistent standards would be a welcomed development for corporations and would eliminate much uncertainty. Assessing insolvency (at the time of the dividend or as its result) should be accomplished with the same diligence as required to insulate the transaction from fraudulent transfer avoidance actions. The generous standard of *Klang,* which requires nothing approaching perfection in determination of insolvency, should not shield directors from liability if the dividend proves to be a fraudulent transfer.

Imposing more stringent fraudulent transfer standards on declaration of dividends would promote responsible decision-making. Any dividend payout drains the corporation's cash resources, impacting its growth opportunities and draining funds available for debt repayment. Debt-funded dividends are inherently risky in that the new debt obligations can put significant constraints on future cash flow. The company's income will need to be allocated to interest payments and, eventually, repayment of the principal upon maturity. This may necessitate raising additional capital by selling more stock and thus diluting current interest holders, or an additional loan or bond issuance may be required in the future. If

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[297] *See, e.g.*, DEL. CODE ANN. tit. 8, § 174(a), (c) (2016) ("Any director against whom a claim is successfully asserted under this section shall be entitled, to the extent of the amount paid by such director as a result of such claim, to be subrogated to the rights of the corporation against stockholders who received the dividend on, or assets for the sale or redemption of, their stock with knowledge of facts indicating that such dividend, stock purchase or redemption was unlawful under this chapter, in proportion to the amounts received by such stockholders respectively.").

[298] *See* Klang v. Smith's Food & Drug Ctrs., Inc., 702 A.2d 150, 152 (Del. 1997) (applying a liberal standard in evaluating directors' authorization of a payout, and allowing the board "reasonable latitude to depart from the balance sheet to calculate surplus." The court required that directors "evaluate assets and liabilities in good faith, on the basis of acceptable data, by methods that they reasonably believe reflect present values." Under this liberal standard, the directors' determination of surplus cannot be "so far off the mark as to constitute actual or constructive fraud.").

directors are subject to a more stringent test under corporate statutes on dividends, they will have more incentive to investigate potential effect of a debt-funded dividend.

In effect, applying fraudulent transfer standards to dividend authorization may shift the directors' focus slightly from their normal responsibility to increase shareholder value to allow them to evaluate the broader prospects of the corporation. These broader interests may include other stakeholders, such as unsecured creditors. Delaware courts have previously rejected the zone of insolvency as the trigger for shifting the beneficiaries of fiduciary duties from shareholders to creditors.[299] But a looming insolvency as a result of a dividend payout is devastating to other corporate stakeholders. Even though shareholders would benefit from a distribution at the time they receive it, in the long run, these shareholders would be worse off than the unsecured creditors because, under the Bankruptcy Code priority of repayment, interest holders are at the back of the line.[300] Furthermore, a potential clawback action is a real and probable threat to any shareholder who receives a fraudulent transfer. Thus, streamlining standards for dividend authorization does not trigger any conflict for directors' fiduciary obligations. To the contrary, the future success of the corporation would be desirable for the unsecured creditors and corporate shareholders alike.

VI. CONCLUSION

The questionable practice of financing dividends with borrowed funds illustrates a dire need to revisit corporate statutes that impose restrictions on dividend payouts. Several jurisdictions, including Delaware, apply lax standards for dividend authorization, allowing directors significant latitude in determining the corporation's financial condition.[301] Even modern statutes that test insolvency as an inability to pay debts when due, in addition to a pure balance sheet calculation, are inadequate and inconsistent with fraudulent transfer laws.[302] Thus, directors often will not be held liable for authorizing dividends even if these dividends turn out to be fraudulent transfers. Yet, shareholder recipients of dividends may be defendants in future avoidance actions which would allow creditors to recover the full amount of the payout. Incorporation of fraudulent transfer standards into corporate-law statutes

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[299] N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

[300] 11 U.S.C. § 507(b) (2012).

[301] *See Klang*, 702 A.2d at 152.

[302] *See* MODEL BUS. CORP. ACT § 6.40 (AM. BAR ASS'N BUS. L. SECTION 2016).

would provide consistency and encourage conscientious decision-making by the board based on diligent determination of solvency. Imposing liability on directors for authorizing fraudulent transfers would also promote responsible borrowing and entice the board to consider various alternatives.

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A REASSESSMENT OF VERTICAL MERGERS WITHIN THE CONTEXT OF ANTITRUST LAWS: THE TIME WARNER AND AT&T MERGER

ALLISON NEFF

ABSTRACT

The development of Antitrust Laws in the United States has a direct correlation to the evolution of merger movements. These Antitrust Laws are still used today to challenge major corporations from consolidating in order to circumvent competition in the market. In June of 2018, AT&T, one of the largest providers of internet and cable, and Time Warner, one of the largest entertainment companies, merged to create Warner Media for $85.4 billion. The merger was contested by the Department of Justice but was affirmed in Federal Court. In the wake of the pending appeal, this note presents the potential aftermath of the AT&T and Time Warner merger. This Note will provide background to the history of mergers, antitrust laws, and government influence on litigating these historically significant mergers. A review of the AT&T and Time Warner decision will give context to the challenges the DOJ will face in the appeals process and will evaluate the effects if the appeal is successful in overturning Judge Leon's decision. In addition, this Note will evaluate a new recommendation of policy concerning vertical mergers and discuss which standards are appropriate in prosecuting them.

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I. INTRODUCTION

On June 12, 2018 the AT&T and Time Warner Merger was affirmed by Judge Leon.[1] Powerful implications of potential transactional behavior follow such an opinion, however, the Department of Justice ("DOJ") filed an appeal on July 13, 2018.[2] In order to understand why this vertical merger was so uncharacteristically challenged by the DOJ and how the outcome of the Court of Appeals will determine future potential merger transactions, a brief review of the history of mergers and antitrust laws, specifically the Clayton Act, would provide insight to this complicated situation and the charges the DOJ asserted. This Note will discuss the role government plays in choosing to litigate certain mergers and the effects government influence had on the AT&T and Time Warner prosecution. An overview of the case itself, including the legal standards that Judge Leon analyzed in order to come to his decision to sustain the merger, will be discussed. Finally, the Note will conclude with a proposal

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*The Court of Appeals held that district court did not err in finding that government failed to show that the proposed merger would violate the Clayton Act, therefore the merger was upheld. *U.S. v. AT&T, Inc.*, 916 F.3d 1029, 1030 (D.C. Cir. 2019).

[1] *See U.S. v. AT&T, Inc*., 310 F.Supp. 3d 161 (D.D.C. 2018), *aff'd sub nom. U.S. v. AT&T, Inc*., 916 F.3d 1029 (D.C. Cir. 2019)(holding that the District Court did not err in finding that the government failed to show that proposed merger would violate the Clayton Act).

[2] *Id.*

for a new legal standard, specifically for vertical mergers, with specific elements that would eventuate a stable and growing economy with little threat of litigation.

II. HISTORY OF MERGERS/BACKGROUND

Mergers gained traction following the Civil War in the form of trusts, later known as cartels.[3] Owners of companies formed the trusts to create a "series of interlocking companies" that appeared to be competitive in the market, but the trusts were in fact establishing monopolies.[4] The first of which was Standard Oil in 1890, controlling all aspects of the industry resulting in the setting of whatever price they desired.[5] The Companies that were circumventing market competition through these monopolies gave rise to antitrust laws enacted by Congress. The consolidation of ninety percent (90%) of the sugar industry in Philadelphia in 1895 was challenged by the U.S. government, but was struck down in a landmark decision. The opinion stated that manufacturing did not constitute "commerce" under the Sherman Act of the Antitrust Laws and thus did not apply.[6] This gave rise to a wave of mergers from 1895 to 1904, resulting in a minority of trusts controlling the majority of manufacturing assets in the U.S.[7] In 1904 the first successful antitrust prosecution known as the Northern Securities decision, the epicenter of President Theodore Roosevelt's campaign, halted merger formations on a grand scale.[8] Since this decision several subsequent Presidents have promised to strengthen antitrust law, which eventually translated into the development of the second major antitrust statute, the Clayton Act.[9] Following the legislation of antitrust laws, merger transactions have ebbed and flowed with the economy and are still a healthy constant in the market today.

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[3] *See* C. Paul Rogers III, *A Concise History of Corporate Mergers and the Antitrust Laws in the United States*, 24 Nat'l L. Sch. India Rev. 10, 11 (2013).

[4] *Id*. at 11.

[5] *Id*. at 11.

[6] *Id*. at 11.

[7] *Id*. at 11.

[8] *Id*. at 12.

[9] ROBERT W. HAMILTON & RICHARD A. BOOTH, *BUSINESS BASICS FOR LAW STUDENTS* 393 (Vicki Been, et al. eds., 4th ed. 2006).

III. ANTITRUST LAWS UNDER THE CLAYTON ACT

The first enacted antitrust legislation was the Interstate Commerce Act of 1887, then the Sherman Act of 1890, and finally the Clayton Act of 1914.[10] The Federal Trade Commission was established that same year in order to enforce federal antitrust laws. The Sherman Act was introduced in order to regulate oppressive business practices associated with cartels and to prevent monopolies. The Sherman Antitrust Act is a federal law prohibiting any contract, trust, or conspiracy in restraint of interstate or foreign trade. The Clayton Act was passed in order to strengthen and clarify the provisions of the Sherman Act, while introducing new regulation regarding price fixing, price discrimination and other unfair business practices. For the purposes of this paper a further analysis of only the Clayton Act is pertinent to the Time Warner merger.

The purpose of antitrust laws is to regulate companies to ensure deceptive trade practices are not used, and ultimately to prevent monopolies from circumventing competition. The Clayton Act identifies acquisitions that have the effect of substantially lessening competition or those that tend to create a monopoly.[11] In the 1912 presidential election, all three candidates stood on the platform that Congress was too lenient on corporations within the bounds of the Sherman Act.[12] After elected, Woodrow Wilson enacted Congress to draft legislation that would strengthen the antitrust laws, which lead to the creation of the Clayton Act.[13] The purpose of the Clayton Act is in direct contention with how Congress treats horizontal and vertical mergers alike and with similar scrutiny. The effects of vertical mergers are far less disruptive to the market than horizontal mergers and are considered competitively neutral by many economic specialists.[14]

In the AT&T and Time Warner merger, the Court had to analyze whether the merger violated the Clayton Act by encouraging post-merger coordinated interaction amongst corporations within the relevant entertainment market. The Court determined that looking at whether the corporation could wield anticompetitive power by utilizing their shared

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[10] *See* http://legalcareerpath.com/antitrust-law/ (last visited November 19, 2018).
[11] 15 U.S.C.A. § 18 (West, February 8, 1996).
[12] https://antitrustlaws.org/clayton-act.html (last visited November 19, 2018).
[13] *Id.*
[14] *See* Michael H. Riordan and Steven C. Salop, Evaluating Vertical Mergers: A Post-Chicago Approach, 63 Antitrust L.J. 513, 516 (1995).

economic interest within the market with respect to "price and output decisions" would be the determining factor in analyzing a Clayton Act violation.[15] Section 7 of the Clayton Act "prohibits acquisitions, including mergers, 'where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition.'"[16] In order for the Court to assess the Government's Section 7 case, an investigation into a 'comprehensive inquiry' of the 'future competitive conditions in a given market,' must be completed within the context of the Clayton Act, in that it protects 'competition,' rather than any particular competitor.[17] In other words, the Clayton Act requires the Court to make a prediction of future market effects in order to rule accurately in the present position, an important shortcoming of the Act in the judiciary system.

IV. GOVERNMENT INFLUENCE

For a number of mergers, "acquirers and/or targets are constituents of U.S. Senators and House Representatives that serve on the U.S. congressional committees charged with oversight of U.S. antitrust regulators. The two committees are the House Judiciary Committee and the Senate Committee on the Judiciary…."[18] Judiciary committees are motivated, and in the most opportunistic position, to influence antitrust outcomes.[19] Government influence as a means of motivation to challenge the merger was raised and dismissed by Judge Leon in his opinion.

AT&T and Time Warner participated in oral argument alleging that the opposition to the merger was politically influenced. Judge Leon refused the request for White House communications with the DOJ. The lawsuit reflected President Trump's opposition to the merger, more specifically his outrage toward Time Warner's CNN.[20] Judge Leon ruled that "Defendants have fallen far short of establishing that this enforcement action was selective," in order to obtain the communications with the

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[15] *Supra* note 1.

[16] Supra note 1 at 190.

[17] *Supra* note 1 at 190.

[18] Mehta, Mihir N. and Srinivasan, Suraj and Zhao, Wanli, *Political Influence and Merger Antitrust Reviews* 1,2 (September 13, 2017). Available at SSRN: https://ssrn.com/abstract=2945020 or http://dx.doi.org/10.2139/ssrn.2945020.

[19] *Id.* at 2.

[20] Shannon Bond, Judge Refuses AT&T Requests for White House Communications Financial Times (Feb. 20, 2018) https://www.ft.com/content/fc713c60-1681-11e8-9e9c-25c814761640.

White House.[21] Historically, democratic administrations in the White House have more frequently opposed mergers than republican administrations. "Vertical merger enforcement is less common than horizontal enforcement. It also varies more from one administration to another. According to our count, there have been forty-six vertical enforcement actions in the 1994–2013 period of twenty years. The DOJ and FTC brought about thirty-one enforcement challenges during the two Clinton administration terms. During the two G.W. Bush administration terms, the two agencies brought only seven enforcement actions. And, through 2013 of the Obama administration, the two agencies have brought eight enforcement actions."[22] It is so uncommon for a republican administration to influence the DOJ to pursue litigation against a merger, and even more rare for the litigation to be aimed at a vertical merger, that the enforcement against the merger is riddled with a "selective" undertone. These actions by the DOJ are especially suspicious given that the DOJ just approved a similar acquisition in late June between Disney and 21st Century Fox with the minor stipulation that Fox spin off its regional sports network.[23] President Trump has a positive relationship with conservative news station Fox, despite his overall scrutiny of journalism, which in turn propagates selective litigation efforts against Warner Media. These were similar mergers in terms of market share and effect, however one is prosecuted and the other is left unhindered.

V. BRIEF HISTORY OF U.S. V. AT&T INC.

The case of U.S. v. AT&T Inc. was highly publicized and was the first challenge to a vertical merger in decades. Judge Leon discussed the burden of proof the government was required to meet in order to enjoin the merger. A further discussion on the effects of Judge Leon's decision is discussed in order to illustrate the precedential influence on future vertical mergers and could change the way litigators present their economic analysis to the court in future lawsuits.

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[21] *Id.*

[22] Salop and Culley, *Potential Competitive Effects of Vertical Mergers: A How-To Guide for Practitioners*, 1, 4 Georgetown L.J. (2014).

[23] Adi Robertson and Makena Kelly, Why yesterday's AT&T and Time Warner merger appeal matters — and why it's a long shot, The Verge (July 13, 2018, 11:01AM) https://www.theverge.com/2018/7/13/17566326/justice-department-att-time-warner-merger-ruling-appeal-explainer.

A. *Burden of Proof*

Judge Leon published his opinion stating that the Government had the burden of proof to demonstrate that the merger is likely to lessen competition substantially.[24] The prerequisite for an illegal acquisition or merger is based on the effect of that action, not the motivation or influences that lead to the merger. In order to satisfy the government's burden of proof that the merger would substantially lessen the competition, the government must show that the effect would be "sufficiently probable and imminent"[25]. The burden of proving the effect would only shift to the Defendant if the government could establish a prima facie case, in which the defense would have to prove through sufficient evidence that the prima facie case "inaccurately predicts the relevant transaction's probable effect on future competition."[26]

This burden is particularly hard for the government to overcome in the event of a vertical merger. A vertical merger consolidates together companies that operate in different parts of a production and distribution chain within the same market, as opposed to a horizontal merger that would combine direct competitors.[27] In the case of a vertical merger the Government can only overcome the burden by presenting a fact specific argument that the effect of the merger is likely to be anticompetitive.[28] The Government failed to provide evidence sufficient to meet this standard and Judge Leon ultimately ruled in favor of the merger.

B. *Effect of Decision*

After careful analysis, Judge Leon attributed his decision to the elimination of double marginalization.[29] Two different firms in the same

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[24] *U.S. v. AT&T Inc*., 310 F.Supp. 3d 161, 165 (D.D.C. 2018) (opinion of Honorable Richard J. Leon).

[25] U.S. v. AT&T Inc., 310 F.Supp. 3d 161, 190 (D.D.C. 2018) (quoting *F.T.C. v. Arch Coal, Inc.*, 329 F.Supp. 2d 109, 115 (D.D.C. 2004)(internal citations omitted).

[26] *U.S. v. AT&T Inc*., 310 F.Supp. 3d 161, 191 (D.D.C. 2018) (quoting United States v. Anthem, Inc., 855 F.3d 345, 349 (D.C. Cir. 2017)(internal citations omitted).

[27] *Supra* note 20.

[28] *U.S. v. AT&T Inc.,* 310 F.Supp. 3d 161, 192 (D.D.C. 2018).

[29] *See U.S. v. AT&T Inc.,* 310 F.Supp. 3d 161, 197 (D.D.C. 2018).

industry merge and effectively decrease their price markups by eliminating their stacked margins, which is ultimately passed on to consumers.[30]

Fortunately, Judge Leon's decision will presumptively have a significant impact on future deals, specifically vertical transactions. "[J]udge Leon's decision is a welcome reminder of the importance of evidence-based antitrust and a triumph of the role of economic analysis in antitrust law."[31] The thorough economic analysis the Court relied on will influence litigators in the future on how they present their evidence and how their expert witnesses will provide insight in future merger cases. Judge Leon's decision to approve the merger encourages other companies within vertical merger stances to bid on other companies.[32] Vertical mergers are seen for what they are after this highly publicized litigation, efficient and pro-competitive.

VI. APPEAL OF U.S. V. AT&T

If the Justice Department successfully appeals the merger, AT&T and Time Warner would be forced to split off the new subsidiary "Warner Media". The Court could fast-track the case and hear it within a few months, which would prevent further integration of the companies.[33] AT&T and Time Warner would be required to pay a break up fee of $500 million if the merger was overturned.[34] The Court of Appeals is unlikely to reverse the merger given the integration of the companies. "Courts are even more reluctant to grant divestiture today and, further, a private litigant faces an uphill battle to prove money damages since it must establish causation between the unlawful merger and its loss of revenue or profits."[35] Warner Media has already begun offering consumers bundled entertainment packages and are driving new customers to sign up for its phone plans.[36] De-integration of the company would have an adverse affect on consumers that are already benefitting from the merger and since

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[30] *Id.* at 197.

[31] Joshua D. Wright and Jan Martin Rybnicek, *AT&T/Time Warner Decision: The Triumph of Economic Analysis*, (June 27, 2018) https://fedsoc.org/commentary/blog-posts/at-t-time-warner-decision-the-triumph-of-economic-analysis.

[32] David Dayen, *The AT&T – Time Warner Merger Is Already What the Government Feared*, THE NEW REPUBLIC MAG. (June 22, 2018), https://newrepublic.com/article/149305/atttime-warner-merger-already-government-feared.

[33] *See Id.*

[34] *Supra* note 1 at 165.

[35] *Supra* note 3 at 28.

[36] *See supra* note 32.

antitrust laws are enforced based on consumer welfare, a successful appeal seems unlikely.

Recent developments of Warner Media's behavior regarding pricing of current customer packages could hurt their case. "Judge Leon's ruling argued that AT&T and Time Warner could offer better and cheaper options to customers by merging."[37] However, immediately following Judge Leon's ruling AT&T increased their price for DirectTV Now Service, pushing consumers to downgrade their service for bundled packages.[38] The main objective of antitrust laws is to regulate the market, which ultimately protects the consumers from price gouging. A decrease in price of DirectTV was specifically stated in the opinion as a reason for merger approval.[39] This may provide the appeals court with the "meaningful real world evidence" the Government needed to meet their burden of proof to enjoin the merger.[40] Such behavior of Warner Media implies that the Government was correct in surmising that the merger would not benefit consumers and price increasing would likely occur. Another issue that was not present in the initial trial but may become a problem in the future is the price increase of the unlimited data plans for the phone services Warner Media is selling.[41] By utilizing the new and exclusive entertainment packages available after the merger to drive their phone plan prices up through data allowances, the DOJ may be able to show "real world evidence" that the merger had an anticompetitive effect.

> "In antitrust parlance, this is known as "tying." As the U.S. Federal Trade Commission notes, "The law on tying is changing. Although the Supreme Court has treated some tie-ins as per se illegal in the past, lower courts have started to apply the more flexible 'rule of reason' to assess the competitive effects of tied sales." But using HBO to drive cell phone subscriptions, when rivals can't do the same, should face legal scrutiny."[42]

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[37] Adi Robertson and Makena Kelly, Why yesterday's AT&T and Time Warner merger appeal matters — and why it's a long shot, THE VERGE (July 13, 2018, 11:01AM) https://www.theverge.com/2018/7/13/17566326/justice-department-att-time-warner-merger-ruling-appeal-explainer.

[38] *Id.*

[39] *U.S. v. AT&T Inc*., 310 F.Supp. 3d 161, 198 (D.D.C. 2018).

[40] *Id.* at 199.

[41] *Supra* note 37.

[42] *Supra* note 37.

This legal argument cannot be introduced at the Court of Appeals, as this is new evidence that was not presented at the initial trial, however it is hard to ignore the behavior of Warner Media in the aftermath of the merger. These actions can present a problem for Warner Media in proving the DOJ's arguments were not without weight, especially in support of their theory of their probable harm argument. The Court can subjectively look at the price increase as non-significant and can show that consumers are getting more for what they were paying for, given the advanced content that wasn't available before, with bundled packages including phone services. Judge Leon relied heavily on the economic analysis presented by experts in Court. "Judge Leon concluded that Dr. Carlton's analysis, which definitively showed that prior instances of vertical integration in this industry have had no statistically significant effect on content prices, could be afforded probative weight in predicting the potential pricing effects of the AT&T/Time Warner transaction."[43] The Appeals Court will likely side with Judge Leon given the substantial amount of economic analysis based on prior transactional history that the vertical merger is unlikely to reduce competition in the market.[44]

VII. RECOMMENDATION OF POLICY

Vertical mergers are less likely to cause market disruption in the form of anticompetitive effects, especially in an oligopolistic market. This ideology should be reflected in the policies and legal standards that govern vertical mergers specifically, instead of utilizing the same legal standards as horizontal mergers.

It is important to note, however, that while some vertical mergers may facilitate oligopolistic coordination, firms may also vertically integrate or merge in order to evade oligopolistic coordination or cheat on a collusive agreement. One example is provided by the wave of acquisitions by cement companies of concrete firms in the 1970s, a merger wave that set off concerns at the FTC that these mergers were facilitating coordination or even collusion, or perhaps foreclosure. On closer examination, however, it appears that cement firms were acquiring concrete companies in order to evade oligopolistic discipline in

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[43] *See supra* note 31.

[44] The Court of Appeals affirmed the decision in the District Court stating that the District Court did not abuse its discretion in denying injunctive relief. *U.S. v. AT&T, Inc.,* 916 F.3d 1029, 1046 (D.C. Cir. 2019).

maintaining cement prices. It is hard to think of a clearer example of the cost of false positives.[45]

Further, the 1984 Vertical Merger Guidelines included quasi-safe harbor provisions for specific oligopolies but broader safe harbor provisions should be reassessed during Guideline revision.[46] The technology sector has expanded so greatly since the adoption of these Guidelines that incentives to integrate, especially in the telecommunications market, greatly motivate vertical mergers today.[47]

Currently, the DOJ has authority to pursue litigation against mergers by benefitting from a presumption of illegality when said merger threatens to create an undue concentration in the market.[48] A merger presents an undue concentration in the market when the surviving corporation will control thirty percent (30%) or more of the total market share, within the proscription of the Clayton Act.[49] Fortunately, the DOJ did not have the benefit of the presumption because the vertical merger did not increase market concentration due to the verticality of the deal. Therefore, the DOJ was required to present evidence of antitrust violations that would substantially lessen competition without the market share evidence to reinforce their argument, which likely changed the outcome of the case.

This can be analyzed in two different ways. One, mergers that result in a surviving corporation that controls less than thirty percent (30%) of the total market share cannot satisfy the requisite standard of illegality of antitrust laws. Two, all vertical mergers are not subject to violation of antitrust laws due to their lack of disruptiveness on the market. A vertical merger that involves elements of a horizontal merger, such as a merger of firms producing complementary products, could avoid needless litigation by offering conditions on the merger.[50]

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[45] Frederick R. Warren-Boulton, *The Contribution of the Merger Guidelines to the Analysis of Non-Horizontal Mergers*, https://www.justice.gov/sites/default/files/atr/legacy/2007/07/11/11709.pdf at 6.

[46] Salop and Culley, Potential Competitive Effects of Vertical Mergers: A How-To Guide for Practitioners, GEORGETOWN L.J. (2014).

[47] *See supra* note 44 at 7.

[48] *See U.S. v. Philadelphia Nat. Bank*, 374 U.S. 321 (1963).

[49] *Id.* at 1.

[50] *See supra* note 45 at 5.

Ultimately a more realistic approach to avoid needless litigation would be to apply a new standard solely to vertical mergers:

1. Vertical mergers should be given the least stringent scrutiny in the review process under Antitrust Laws given their non-disruptive effect on the market.[51]

    a) The Burden of Proof should be placed on the Government to show substantial anticompetitive behavior.
    b) A presumption of good faith should lie with the corporations and the structural presumption should automatically apply.[52]
    c) *Note:* A review and revision of the Clayton Act could adapt this new standard.

2. Elements

    a) Vertical merger must lack substantial horizontal merger elements; and
    b) Result in minimal anticompetitive effects on the current or immediate future of the market.

These proposed elements would counter wasteful litigation in the event of a routine vertical merger. Emerging markets, such as the technology sector, should be celebrated and advocated by the judicial system, not delayed and countered due to political influence and frivolous concerns of monopolizing markets.[53] The elements would specifically address vertical mergers and how to proceed through them during a judicial review process, as opposed to relying on subjective interpretations of common law or borrowing outdated prose from the non-horizontal merger guidelines. The vertical guidelines should be revised and reviewed by the DOJ, not only by the companies, as their purpose is to "inform

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[51] *Contra* Michael H. Riordan and Steven C. Salop, Evaluating Vertical Mergers: A Post-Chicago Approach, 63 ANTITRUST L.J. 513, 516 (1995).

[52] *Supra* note 31 ("The DOJ's loss in AT&T/Time Warner is a reminder that the structural presumption is a powerful tool for the government and one that may be doing real harm if it allows the antitrust agencies to win merger challenges even when they cannot produce evidence sufficient to carry their burden of showing that the transaction is likely to harm consumers.").

[53] *U.S. v. AT&T Inc*., 310 F.Supp. 3d 161, 193 (D.D.C. 2018).

parties which economic scenarios the Agencies will take seriously when considering potential anticompetitive effects (e.g., raising entry barriers, collusion, regulatory evasion) or efficiencies (e.g., counteracting the incentive to free ride)."[54] Further, the DOJ should only pursue litigation of mergers that have been subject to investigation and show elements of horizontal merger concerns. The DOJ should not be influenced by political motivations and government insistence to pursue vertical mergers. Once a merger, subject to investigation, passes muster of the previously cited elements, the DOJ should not halt business transactions.

VIII. CONCLUSION

In conclusion, the Appeals Court will most likely affirm the decision approving the merger of AT&T and Time Warner. Businesses can take a cue from this likely outcome and focus on acquiring businesses that would satisfy a vertical merger in order to stay relevant in the evolving landscape of business. The Court should be wary of government influences of merger reviews beyond the "selective" standard currently in play in order to keep the markets healthy and competitive.[55] Reviewing vertical mergers under the standard of per se illegality is misguided and ignores the underlying economic opportunity costs. Therefore, a new standard should apply for vertical mergers that satisfy the proper characteristics of a non-threatening merger. Promoting business transactions with little resistance from potential litigation would protect companies and advocate for a growing stable economy. The Antitrust laws are better served when the consumer reaps the benefits from vertical integration, such as the AT&T and Time Warner merger.

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[54] *Supra* note 45 at 8.
[55] *See supra* note 20.