Creditors Strike Back at PE's Bankruptcy Raids

Turnarounds & Workouts

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Allegations by creditors' committees and litigation trustees that private equity sponsors have engaged in fraudulent transfers, unlawful dividends, and asset stripping of bankrupt portfolio companies are becoming commonplace in large corporate restructurings. One commentator charged private equity sponsors with engaging "in increasingly aggressive tactics that tilt the playing field in their favor, by siphoning value away from creditors for their own benefit prior to and during bankruptcy proceedings." In a recent decision, Judge Robert Drain, then of the Southern District of New York Bankruptcy Court, cited several studies and noted:

"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. As of November of 2018, more than $30 billion in borrowed funds was paid out by companies to their PE owners. Studies show that 25% of 481 large Chapter 11 filings over six years (from mid2011 through mid-2017) were by PE-owned companies. In 2017, 30% of Chapter 11 filers were owned by PE funds." There is little doubt that the same playbook has been followed since the dates of the foregoing analyses and will continue to be followed unless Congress acts.

Private equity sponsors are struggling to maintain the substantial and regular returns/liquidity events expected by their investors. For example, recent industry reporting indicates that many funds that acquired portfolio companies in 2019-2021 are straining to meet returns that match their investors' expectations and deliver successful exits on the timelines originally promised. 2025 was the weakest year for private equity returns since 2011. Under these conditions, private equity sponsors have significant incentive to push for large dividends to satisfy investor expectations, regardless of whether the underlying economics of the portfolio companies can support them.

In response to this trend, creditors' committees and litigation trustees are successfully pursuing remedies against this self-interested and value-destructive behavior. Recent cases provide a roadmap for successfully clawing back illegal dividends from private equity sponsors of bankrupt companies. The leading case is the trustee litigation brought in connection with the bankruptcy of Tops Holding, owner and operator of 169 supermarkets in upstate New York, northern Pennsylvania, and Vermont. There, the trustee of the Tops Holding Litigation Trust brought suit against Morgan Stanley, HSBC, and other private equity sponsors of Tops to recoup over $375 million in dividends paid out to the sponsors. Judge Drain presided and largely denied the defendants' motions to dismiss the trustee's claims.

Judge Drain found that the trustee had adequately alleged that the payments made by Tops in connection with the four challenged dividends were both constructively and actually fraudulent under New York law. In his decision, Judge Drain held that the statutory safe harbor contained in 11 U.S.C. §546(e)— which restricts a trustee's power to avoid certain transfers in connection with securities contracts—does not insulate transfers from recovery by creditors simply because they were funded by the issuance of notes. Other S.D.N.Y. bankruptcy judges have since followed Judge Drain's 546(e) decision. See In re IIG Global Trade Fin. Fund Ltd., 666 B.R. 38, 60 (Bankr. S.D.N.Y. 2024); In re GBG USA Inc., 666 B.R. 115, 143 (Bankr. S.D.N.Y. 2024). Judge Drain also found that trustees seeking to exercise their avoidance powers are not necessarily constrained by state statutes of limitations, and can instead look back further by relying on proofs of claims asserted in the bankruptcy by certain creditors who have longer statute of limitations (in that case, the IRS). Judge Drain also declined to dismiss the Trustee's unlawful dividend claims against the defendants. The Tops litigation ultimately settled for a confidential sum while summary judgment motions were fully briefed and sub judice.

Current Major Litigation

More recent litigation has followed in the footsteps of Tops. In November 2024, the litigation trustee appointed in connection with the bankruptcy of Instant Brands, a kitchen appliance company that sold a popular consumer goods product, the Instant Pot, sued the former private equity sponsor, Cornell Capital, and certain former directors and officers of Instant Brands, seeking to recover over $400 million in dividends and other fraudulent transfers from the company in the run-up to its June 2023 bankruptcy filing. The litigation trustee asserted that Cornell and certain directors and officers engaged in fraudulent transfers, breaches of fiduciary duty, illegal dividends, and fraudulent misrepresentations in connection with the dividend recapitalization and later transfers. On Aug. 5, 2026, Judge Margaret M. Garnett of the District Court for the Southern District of New York issued a decision denying the defendants' motions to dismiss in full.

A similar case was brought in connection with the bankruptcy of High Ridge Brands. There, a liquidating trustee brought suit against controlling private equity firm CD&R seeking to recover over a hundred million dollars based on claims of actual fraudulent transfer, breach of fiduciary duty, and common law fraud in connection with a recapitalization of High Ridge Brands allegedly directed by CD&R. Judge Brendan Shannon, of the Delaware Bankruptcy Court, declined to dismiss the trustee's claims, including because he found that the defendants' section 546(e) safe harbor defense required further factual development, citing Tops. The case remains pending, with briefing on summary judgment and motions to exclude experts on file.

Significant litigation against a private equity sponsor is also ongoing in connection with the 2023 Lucky Bucks bankruptcy. There, two lawsuits have been brought, each seeking to recover over $200 million in allegedly fraudulent transfers and improper dividends paid out at the direction of the companies' private equity sponsor. In one of the cases, in March 2026, Judge Karen Owens of the Delaware Bankruptcy Court issued a decision on defendants' motions to dismiss allowing most of the claims to go forward.

Assessing Claims

The primary claims challenging dividends and other transfers out of a company are fraudulent transfers (both actual and constructive), illegal dividends, breach of fiduciary duty, and aiding and abetting breach of fiduciary duty. For actual fraudulent transfer claims, the plaintiff must show the debtor made the transfer with the actual intent to hinder, delay, or defraud its creditors. For constructive fraudulent transfer claims, a plaintiff must show, inter alia, that a company was insolvent at the time the transfers were made. To show insolvency, plaintiffs and their experts should rely on evidence contemporaneous with the challenged dividend and not rely on hindsight evidence. If insolvency can be shown, not only can the transfer be avoided, but it also alters the fiduciary duties of officers and directors—once a corporation is insolvent, directors and officers owe duties to creditors, not shareholders, making dividends to private equity sponsors essentially per se breaches of duty.

Private equity sponsors typically install their own employees as majority members on the board of directors of their portfolio companies. This makes the private equity sponsors and their designated directors particularly vulnerable to breaches of duty and aiding and abetting beach of duty claims. A director beholden to the sponsor who will directly benefit from the challenged dividend is conflicted and likely in breach of his duty of loyalty to the company. Typically, the sponsor is involved in the dividends, providing direction and support to its employees on the board, which supports aiding and abetting claims against the sponsor.

Takeaway

Private equity sponsors are increasingly engaging in aggressive maneuvers to obtain returns on their failing investments in portfolio companies. A common maneuver is to take large dividends approved by a conflicted board of directors. This has led to needless bankruptcies and massive creditor losses. Recent court decisions demonstrate that trustees representing the interests of creditors can often recover these transfers from the private equity sponsors by bringing the claims described above.

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