TOO LITTLE, TOO LATE: SHORTCOMINGS OF MODERN FRAUDULENT TRANSFER LAW

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ABSTRACT

Fraudulent transfer law seeks to undo transactions that actually or constructively defraud creditors. When used in bankruptcy, however, this mechanism comes too late in the process to prevent the real harm from taking place. As the market for financing poorly rated companies has expanded, creditors have, sometimes in anticipation of future insolvency, utilized new, super-priority liens to jump the line of existing creditors at their expense. These financiers, positioning themselves in the ranks of secured creditors increasingly sooner in the journey towards bankruptcy, exploit the need for future financing in exchange for control of the bankruptcy, suggesting that stronger tools should be made available to trustees and debtors in possession to prevent fraudulent actions before they are ingrained in the bankruptcy process. This paper will explore the emerging opportunities for debtor-in-possession financing and the ways creative creditors take over this process while suggesting that these seemingly modern leveraged buyouts can and should be avoided by greater oversight prior to bankruptcy to best maximize corporate value, in and out of bankruptcy.

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INTRODUCTION

Fraudulent transfer law has existed in some form since the 16th century in England. Regulators, then and now, are concerned with debtors taking advantage of their creditors through fraudulent transactions that harm the potential recovery for creditors.

However, as bankruptcies and corporate structures has grown significantly more complex through the 20th century, the existing framework of fraudulent transfer enforcement has failed to grow with it. Fraudulent transfer laws are enacted outside of bankruptcy laws on the state level to be applied in a variety of contexts, not just bankruptcy. Because the focus of these laws are not exclusively on their impact in a bankruptcy proceeding, their effects in the current bankruptcy scheme are not enough to prevent the transactions that fraudulent transfer laws were intended to prevent. Furthermore, since fraudulent transfer laws first developed in the United States, significant changes to both bankruptcy law generally and how businesses act in Chapter 11 cases have occurred.

Since the introduction of these laws, the focus has been squarely on preventing debtors from defrauding their creditors through fraudulent transactions, while turning a blind eye to other participants in these financial structures – namely creditors. The prevailing creditors-can-do-no-harm sentiment gives creditors substantial power in bankruptcy, pitting creditor against creditor for bankruptcy pole position. Though fraudulent transfer actions are often associated with the bankruptcy process, the foundations for fraud are set far before the petition is filed, when creditors jockey for position to cement themselves as the primary debt financier. This struggle for positioning, paired with complex modern corporate structures, has led to the emergence of new techniques for debtors and creditors to alter the value of the bankruptcy estate and reduce the recovery of lower-position creditors.

To maximize the value of the bankruptcy estate, fraudulent transfer law enables trustees and debtors in possession to undo transactions intended to subvert this goal. Constraints on DIP financing and the late-stage nature of bankruptcy in the life of a distressed company gives debtors the opportunity to undertake suspect transfers to obtain debtor-in-possession financing while minimizing their exposure to fraudulent transfer litigation. This paper argues that both greater oversight over fraudulent transfers prior to bankruptcy and changes to fraudulent transfer and bankruptcy laws are needed to prevent these types of transactions.

This paper will explore the background and evolution of debtor-in-possession financing and fraudulent transfer law into its modern form, concluding with several recommendations on changes that target the issues elicited in this paper. Part I will explore the historical background of fraudulent transfer law. Then, Part II will

evaluate will evaluate trends within modern bankruptcy practices. Part III reveals the historical and legal underpinnings of such concepts, before Part IV assesses contemporary issues arising from modern applications. Finally, this paper concludes with several recommendations for addressing these problems and mitigating future impacts.

I. HISTORICAL BACKGROUND

Fraudulent transfer law has played an integral part in preventing debtors from unfairly taking advantage of creditors and decreasing the size of the bankruptcy estate at creditors' expense. Because of its non-bankruptcy background, fraudulent transfer law developed differently in each state, with some states adopting more modern laws while others stick closer to the original English purpose discussed below. To understand the full scope of how current fraudulent transfer law misses the mark when it comes to preventing fraudulent transactions, it is important to trace the development of American fraudulent transfer law and the emergence of new trends in bankruptcy to the present day. Such an evaluation reveals that fraudulent transfer law has outgrown its original purpose and is contributing to growing issues in U.S. bankruptcy law more broadly.

A. History of Fraudulent Transfer Law

Fraudulent transfer law has existed in some form since 1571 when 13 Statute Elizabeth was passed in England.[1] Fraudulent transfer law developed from this English rule in the American colonies until their independence, when the states began to take up their own common law versions of the statute. Due to its common law beginnings, fraudulent transfer law evolved differently in each respective state, resulting in lookback periods – the time an existing creditor has to initiate a fraudulent transfer action[2] – ranging from four[3] to six years.[4] During the early 20th century, several codifications of state fraudulent law transfer took place, beginning in 1918 with the Uniform Fraudulent Transfer Act ("UFTA") and culminating with the Uniform Voidable Transactions Act ("UVTA") in 2014.[5] Today, fraudulent

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[1] *See* Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 BANKR. DEV. J. 55, 55 (1991); Fraudulent Conveyances Act 1571, 13 Eliz. c. 5 (1571).

[2] Unif. Voidable Transfer Act § 9 (2014).

[3] N.Y. Debt. & Cred. Law § 278(a) (Consol. 2023) (New York's lookback period for fraudulent transfers is four years).

[4] Mich. Comp. Laws Serv. § 566.39(A) (LexisNexis 2023); *see also* Mich. Comp. Laws Serv. § 600.5813 (Michigan's lookback period for fraudulent transfer actions is six years).

[5] 5 COLLIER ON BANKR. ¶ 548.01[2][a][ii] (16th ed. 2024).

transfer law is also codified in the Bankruptcy Code ("Code") in 11 U.S.C. § 548, creating a uniform statute for bankruptcy practitioners and creditors to draw on.[6] § 548 allows trustees to:

> "[A]void any transfer … of an interest of the debtor in property or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition…"[7]

The Code recognizes two areas where fraudulent transfers can be avoided: (1) when the transfer was made with "actual intent to hinder, delay, or defraud,"[8] and (2) when the debtor "received less than a reasonably equivalent value" for the transfer,[9] commonly referred to as "actual" and "constructive" fraudulent transfers, respectively. Practically, an "actual" fraudulent transfer requires intent on behalf of the transacting party to defraud their creditors. Conversely, "constructive" fraudulent transfers can happen with or without the debtor's knowledge, with no intent requirement for there to be a finding. For purposes of the Code, an "insider" includes directors, officers, partners, relatives, and *a person in control of the debtor*.[10]

Simultaneously, the Code contains § 544, permitting bankruptcy trustees to avoid transfers that unsecured creditors can avoid under state fraudulent transfer law.[11] In addition to extending the lookback period beyond § 548's two years, this provision allows trustees to take advantage of additional state laws in bringing fraudulently transferred property back into the estate, increasing its value for creditors.

Outside of avoiding fraudulent transfers, the Code, under § 547, empowers trustees to avoid preferences, or transactions involving the debtor while they are insolvent just before the petition date.[12] Trustees can avoid all preferences undertaken in the ninety days before the petition date,[13] and preferences between the debtor and insiders for a full year before the petition date.[14] This broadens the scope of the types of transactions trustees can avoid by clawing back transfers

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[6] *See* 11 U.S.C. § 548.
[7] 11 U.S.C. § 548(a)(1).
[8] 11 U.S.C. § 548(a)(1)(A).
[9] 11 U.S.C. § 548(a)(1)(B)(i).
[10] 11 U.S.C. § 101(31) (defining "insider," including "person in control of the debtor").
[11] *See* 11 U.S.C. § 544(b); Williams, *supra* note 1, at 57.
[12] 11 U.S.C. § 547(b).
[13] 11 U.S.C. § 547(b)(4)(A).
[14] 11 U.S.C. § 547(b)(4)(B).

made on the eve of bankruptcy, but reinforces the distinction between transfers to general creditors and transfers to insiders in enforcement actions.

Sections 544, 547, and 548 allow trustees to avoid fraudulent transfers and preferences as identified in the Code as well as fraudulent transfers as defined by state law, but § 550 enables trustees to recover the fraudulently transferred property.[15] This statute gives teeth to the fraudulent transfer claims through the use of federal law to enforce them. The Code enables the recovery of property fraudulently removed from the estate, but it also works to expand who is eligible to wield such powers during the bankruptcy process.

Although trustees are automatically appointed in Chapter 7[16] and 13[17] bankruptcies, Chapter 11 differs in that organizational debtors may forego the appointment of a trustee[18] and remain in possession of the bankruptcy estate as debtors-in-possession ("DIPs"). DIPs are afforded (with few exceptions) the same rights and powers of a trustee.[19] Organizational debtors usually take advantage of DIPs because existing management is familiar with the operations of the debtor's organization and does not require any additional time to come up to speed like an unfamiliar trustee. Thus, the provisions of the Code which empower trustees to act for the benefit of the estate also apply to DIPs overseeing the bankruptcy process, maintaining debtor control throughout the reorganization.

State fraudulent transfer law, found in the codification of different versions of the UVTA, works in tandem with the Code giving trustees another weapon in fighting fraudulent transfers. As discussed, fraudulent transfer law under § 548 of the Code allows DIPs to recover property fraudulently transferred within the two-year time limit, however, this section alone does not empower those debtors to take actions to recover the property. Instead, they must rely on the Code's § 550 and corresponding state-enacted versions of the UVTA that weaponizes the § 548 fraudulent transfer action. For instance, a debtor in a North Carolina bankruptcy court is entitled to recover fraudulent transactions under the Code within two years like a debtor in bankruptcy court anywhere else in the US. But it is North Carolina's version of the UVTA that gives the debtor an actional statute to claw

[15] *See* 11 U.S.C. § 550.

[16] *See* 11 U.S.C. § 701 (providing that a Chapter 7 trustee is automatically appointed after the petition is filed).

[17] *See* 11 U.S.C. § 1302 (providing that a Chapter 13 trustee is automatically appointed after the petition is filed).

[18] *See* 11 U.S.C. § 1104 (allowing for the appointment of a trustee upon request by an interested party after petition but not requiring it).

[19] *See* 11 U.S.C. § 1107.

back this property.[20] Further, § 544 grants debtors the power to avoid transfers under state law, extending the scope of the Code beyond § 548 to encompass state-enacted rights including longer claw-back periods and reliance on the local UVTA for enforcement of fraudulent transfer actions.

To better understand fraudulent transfer law, it helps to take a step back from the Code provisions authorizing these actions to see its intended purpose in the bankruptcy process. One of the goals of bankruptcy is to maximize the value of the bankruptcy estate so that all creditors can collect the highest possible amount from the plan.[21] Fraudulent transfer law supports this goal by "ensuring the honesty and reasonableness of a debtor's transfers by condemning transfers that may result in an unexpected harm to a debtor's unsecured creditors."[22] Fraudulent transfer law has allowed for trustees and debtors to bring additional property back into the estate to be distributed to creditors. Attempts to prevent trustees from undertaking fraudulent transfer litigation harm the estate and make the creditors worse off. Sections 544, 547, and 548 of the Code, in addition to each state's fraudulent transfer laws, work together to maximize the value of the estate for the benefit of creditors and assist the debtor in their reorganization.

B. Analyzing Fraudulent Transfers with Badges of Fraud

A seminal case in the development of English (and later American) fraudulent transfer law is *Twyne's Case*, an English case from 1601 where the court relied on several warning signs to find actual fraud.[23] The impact of these 'badges of fraud' on modern bankruptcy law can be seen in their codification in § 4(b) of the UVTA, adopted across the states as signals pointing to a fraudulent transaction.[24] Courts, in determining actual intent of fraud, should consider whether: (1) a transfer was to an insider, (2) the debtor retains control over the property after the transfer, (3) a transaction is secret, (4) before the transfer, the debtor was threatened with legal action, (5) the transfer was for substantially all of the debtor's assets, (6) the debtor fled, (7) the debtor hid assets, (8) the consideration given for the transfer was nominal or $0, (9) the debtor was insolvent or was insolvent quickly after the transaction, (10) the transfer took place soon before a substantial debt was

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[20] N.C. GEN. STAT. § 39–23.4 (2023).

[21] *See* Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, 39 YALE J. ON REGUL. 1, 7 n.23 (2022).

[22] Jack F. Williams, *The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System*, 15 CARDOZO L. REV. 1403, 1414 (1994).

[23] *See Twyne's Case* 76 Eng. Rep. 809 (Star Chamber 1601).

[24] Unif. Voidable Transaction Act § 4(b) (2014).

incurred, and (11) the debtor transferred essential assets of the business to a creditor who then transferred the assets to an insider. Courts may opt to use badges together, alone, or not-at-all in finding fraud.[25] The badges of fraud provide a simple set of factors to assess when analyzing transactions involving insolvent companies. Their flexibility and ease of use indicate that use prior to and in the midst of bankruptcy by judges and creditors would aid earlier enforcement of fraudulent transfer law.

C. History of Debtor-in-Possession Financing

In large bankruptcy filings, organizational debtors require substantial cash to continue operating the business through bankruptcy until plan confirmation. The primary issue facing debtors in securing this post-petition funding is that they have already filed for bankruptcy or are close to doing so, showcasing the riskiness of lending them money. In Chapter 11 cases in particular, debtors will often utilize their DIP capabilities to remain in control of the business through the bankruptcy process instead of conceding to a trustee.[26] Because soon-to-be debtors are generally cash-poor, the easiest place for them to find bankruptcy funding is in their existing debt structure with preexisting creditors who have an interest in the debtor's successful emergence from bankruptcy. However, potential DIP lenders are cautious about loaning additional money to debtors, often requiring more security than usual to offset the higher risk.[27]

Section 364 governs how DIPs may obtain this needed funding, creating several different avenues for debtors with or without the Court's consent. Debtors are empowered to obtain financing without the Court's approval in the form of unsecured debt without priority as long as this funding is obtained through the ordinary course of business.[28] Creditors extending this type of funding are entitled to priority as an administrative expense, but not a super-priority lien or other jump-the-line standing. If a debtor needs to obtain financing outside the ordinary course of business, they may do so after notice and hearing with the permission of the Court.[29] Funding extending under § 364(b) becomes an administrative expense like

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[25] 5 COLLIER ON BANKR., *supra* note 5, at ¶ 548.04[1][b][ii]; *See also* Bear Stearns Sec. Corp. v. Gredd (*In re* Manhattan Inv. Fund Ltd.), 397 B.R. 1, n. 13 (S.D.N.Y. 2007) ("'Badges of fraud' do not create a presumption of fraudulent intent, however, but merely facilitate the analysis.").

[26] 11 U.S.C. § 1107.

[27] *See* Whirlpool Corp. v. Wells Fargo Bank (*In re* hhgregg, Inc.), 949 F.3d 1039, 1042 (7th Cir. 2020).

[28] 11 U.S.C. § 364(a).

[29] 11 U.S.C. § 364(b).

in § 364(a) and there is no additional priority for lenders.

Unfortunately, some debtors have trouble finding financing through these two avenues and need to provide additional incentives to would-be DIP financiers to entice them to provide this funding. Section 364(c) allows debtors to, after notice and hearing and with the permission of the Court, provide DIP lenders with three different advantages to accompany their loan: (1) priority over any or all administrative expenses, (2) a new lien over property without a preexisting lien, and/or (3) a junior lien on property with a preexisting lien.[30] In many cases, debtors will offer lenders a combination of two or three of these choices to increase the security of the debt financing.[31] In certain circumstances, debtors are unable to obtain funding even with these incentives, allowing them to ask the Court to approve, after notice and hearing, a super-priority lien over all other preexisting liens if the debtor can make a showing that funding is otherwise unavailable and that existing lienholders are adequately protected.[32] Section 364(d) gives would-be DIP lenders the highest likelihood of recovering their loan, often at the expense of preexisting lienholders who were not selected as the DIP financier. A debtor's ability to obtain debt financing through these incentives allows them to continue operating through their Chapter 11 proceeding but carries with it the risk associated with shifting creditor priority on the eve of bankruptcy, creating points of contention among creditors. Routine DIP financing agreements present tremendous upsides to debtors, however, in the past decade, what can be a helpful financing tool for insolvent companies has morphed into a complex fight for control among creditors.

II. TRENDS IN MODERN BANKRUPTCY

Over the past forty years, corporate structures have grown increasingly complex. Firms have shifted how they borrow, choosing to finance their operations through secured debt, rather than unsecured debt.[33] This trend has led to companies with several different priority-levels of liens rather than large groups of unsecured creditors.[34] One benefit of having tiered lienholders is that debtors are less tied to one particular DIP lender for financing, allowing for different lienholders to offer competing bids to the debtor.[35] However, this lien structure can invite creditor-on-

[30] 11 U.S.C. § 364(c).

[31] *See* 3 COLLIER ON BANKR. ¶ 364.04[1] (16th ed. 2024).

[32] *See* 11 U.S.C. § 364(d).

[33] *See* David Skeel, *Bankruptcy's Identity Crisis*, 171 U. PA. L. REV. 2097, 2099 (2023).

[34] *See id.*

[35] *See id.* at 2100.

creditor violence. Creditors, in anticipation of the impending insolvency of their debtor, often look at their existing loan agreements, exploiting chinks in the armor to restructure their loan to obtain super-priority over other preexisting lien holders.[36] The presence of a variety of secured creditors with significant stakes in the debtor encourages them to assert their position among the lien hierarchy to best position themselves at the expense of their lienholder comrades.

As bankruptcy unfolds, debtors, strapped for cash to continue operating their business, must find sources of continued financing. As discussed before, DIP borrowers have few choices when it comes to borrowing additional funds, often requiring them to turn to their preexisting secured creditors to make up the difference. Modern DIP lenders have been willing to offer DIP financing,[37] but these agreements come with a catch. DIP lenders have utilized restructuring support agreements ("RSA") to negotiate additional terms the DIP borrower must abide by in accepting the funding.[38] These terms can vary depending on the desires of the creditor, but they often control the length of the bankruptcy, provide creditor protections, and offer post-bankruptcy compensation for the debtor's managers.[39] Debtors, when presenting these agreements to the court for approval, often face pushback from judges and the U.S. Trustee, indicating some skepticism by the courts towards these agreements. Notwithstanding these hesitations, many RSAs are eventually approved, bringing debtors and their bankruptcy financiers ever closer. Kenneth Ayotte and Jared Ellias have dubbed this pre-petition negotiation the "bankruptcy process sale" as it allows for senior lienholders to transfer significant control over the trajectory of the bankruptcy to creditors.[40]

This transition to the modern age of bankruptcy has seen an evolution of creditor control of debtors through RSAs. In their analysis of 175 DIP loan contracts from 1995 to 2018, Ayotte and Ellias found that loans fell into one of three categories: management control (DIP loans with few strings attached), limited discretion loans (managers have milestones by which they must do certain things), and loans in exchange for a preidentified transaction favored by the DIP lender.[41] In their sample, by 2018, 86% of DIP loan contracts were subject to milestones and 50% subject to a specific prepackaged plan.[42] Today, senior creditors routinely ask for more control over the bankruptcy process in exchange

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[36] Diane L. Dick, *Hostile Restructurings*, 96 WASH. L. REV. 1333, 1336–37 (2021).

[37] These cases include the bankruptcies of Neiman Marcus, J. Crew, and others.

[38] *See* Ayotte & Ellias, *supra* note 22, at 2–3.

[39] *See id.* at 3.

[40] *See id.* at 3–4.

[41] *See id.* at 10–12.

[42] *See id.* at 14.

for DIP financing that keeps the debtor operating through restructuring.[43] Across the range of the transactions surveyed, it is clear that the ease of obtaining court approval for creditor control over the bankruptcy process has encouraged lenders to demand – and ultimately take – more and more control, culminating in the ever decreasing control debtors exert as identified by Ayotte and Ellias. RSAs and pre-packaged bankruptcies are common methods DIP financiers use to take control of debtors and position themselves ahead of other creditors.

Another feature of modern bankruptcy is the use of leveraged loan borrowing.[44] Leveraged loans are loans made to borrowers with high levels of preexisting debt and/or a low credit rating.[45] These loans have increasingly been made to struggling medium and large corporations, showcasing the lucrative opportunity for private equity ("PE") firms to take the place of traditional lenders in this area.[46] A second aspect of PE's role is the increasing prevalence of PE firms offering debtors secured, rather than the historically predominant unsecured, loans.[47] PE firms use these loan offerings to enter into the hierarchy of secured lenders, gain additional peace of mind over future repayment, and to encourage debtors to undertake an efficient restructuring.[48] PE encouragement of debtors has increasingly taken the form of their direct participation in the restructuring process through providing the much needed financing to keep debtors operating through the bankruptcy process. The opportunity to enter the capital structure of distressed companies far in advance of a bankruptcy petition allows for PE firms to position themselves in the array of secured creditors, only to later leverage this position as a DIP lender while avoiding the scrutiny of traditional claw-back inquiries. Further, the PE investors, in exchange for their much-needed financing, become tied to the debtor through RSAs and high-priority liens, elevating their position as debtors file for bankruptcy.

With the existing fraudulent transfer laws and perceived acceptance of these suspect transactions, there are few safeguards strong enough to prevent harm to other creditors. Without changes, the market for opportunities to take advantage of soon-to-be insolvent companies at the expense of their creditors will continue to

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[43] *See id.* at 15.

[44] Skeel, *supra* note 34, at 2103.

[45] *Leveraged Loan Funds*, U.S. SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-0 (last visited Feb. 4, 2024) [https://perma.cc/443V-KDEZ].

[46] Skeel, *supra* note 34, at 2105.

[47] *Id.* at 2106.

[48] *Id.* at 2107.

expand with the potential harm growing alongside it.

David Skeel points out a final component of modern capital structures: greater complexity of companies.[49] Although companies today have greater abilities to coordinate, the increasing complexity of those firms has made coordinating more difficult.[50] Skeel identifies two areas of complexity, the first arising from the use of multiple entities within an enterprise, and the second coming from third parties' ability to anticipate gaps in loan agreements.[51] These levels of complexity allow sophisticated lenders to take advantage of the inevitable gaps in DIP financing documents.[52] Skeel points out that these three aspects of modern bankruptcy, the prevalence of secured liens, reliance on leveraged loans, and the complexity of modern companies, have given rise to hostile restructuring of these distressed companies.[53]

III. MODERN BANKRUPTCY TRENDS IN ACTION

These modern aspects of bankruptcy and corporate structures have created unique opportunities for companies in bankruptcy. Several notable cases in the past decade have exhibited different ways firms have found to exploit these weaknesses. However, these debtors are not working alone. Problematic transactions would not be possible without the assistance of DIP lenders and other newfound insiders looking to benefit from the bankruptcy process. Two of the main ways that debtors have conducted these suspect transactions are through 'uptiering' exchanges and 'trapdoor' transactions. These transactions are made possible through DIP financing agreements pushed by senior creditors looking for their preferred outcome of the bankruptcy – often at the expense of other creditors.

A. Uptiering Exchanges

'Uptiering', or the issuance of new, secured, super-priority debt, creates a new class of secured lienholders above the preexisting ones.[54] However, much to the chagrin of the losing creditors, these super-priority lienholders often emerge from a preexisting class of secured creditors where some gain priority while others' claims are subordinated.[55] The opportunity for this type of transaction and the shifting of lien priority is a direct result of the prevalence of leveraged DIP

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[49] *Id.* at 2107.
[50] *Id.* at 2107–08.
[51] *Id.*
[52] *Id.*
[53] *Id.* at 2108–09.
[54] *See* Dick, *supra* note 37, at 1352.
[55] *See id.*

financing agreements. In exchange for much-needed liquidity, these agreements shift certain favored creditors into the highest position, increasing both their likelihood and the size of their recovery, all at the expense of other formerly situated priority lienholders.

This type of transaction captured national attention when Serta utilized it in its recent restructuring. In June 2023, the U.S. Bankruptcy Court for the Southern District of Texas confirmed Serta's Chapter 11 Plan, even with the uptiering transaction that gave super-priority to some creditors while demoting others.[56] Serta, facing losses and a highly leveraged balance sheet, engaged several of their secured creditors in negotiations to try and restructure their secured debts, resulting in two proposals, the first (and ultimately selected) proposal to conduct an uptiering transaction, and the second, a transfer of valuable collateral away from lenders so it could be used to obtain new loans.[57][58] In the uptiering transaction, a group of preexisting lenders, large enough to form a majority, handed over the high-priority debt, while the remaining secured creditors were left with lower-priority debt, now carrying a lower market value.[59] This allowed Serta to continue its reorganization with financing and left disfavored creditors worse off than before the bankruptcy petition was filed.

Although the uptiering transaction was ultimately allowed in *Serta*, lurking behind the transaction is the invisible hand of fraudulent transfer, benefiting certain stakeholders at the expense of creditors and debtors. As uptiering exchanges increase in frequency, courts should prepare for challenges to these transactions and must be prepared to make conclusive rulings on their legitimacy. A tool courts can utilize in this analysis is the badges of fraud. Several of these badges were present in *Serta*, and the transaction could have reasonably been found fraudulent. First, the successful transaction's creditors were preexisting creditors who wielded significant control over the debtor during the negotiations prior to their bankruptcy petition.[60] Transfers to insiders, people with control over the debtor,[61] are clearly

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[56] *See* Gordon Houseman et al., *Serta's 'Uptiering' Maneuvering Approved by U.S. Bankruptcy Court*, SHEARMAN & STERLING (June 9, 2023), https://www.aoshearman.com/en/insights/sertas-uptiering-maneuvering-approved-by-us-bankruptcy-court [https://perma.cc/Y4KJ-3CE5].

[57] *See* Dick, *supra* note 37, at 1354–55.

[58] Although not selected by the DIP, the losing proposal in *Serta* came in the form of a "trapdoor" transaction that, as discussed further, presents its own problematic implications. *See id.*, at 1355; *infra* Part IV.B.

[59] *See* Dick, *supra* note 37, at 1355–56.

[60] *See id.* at 1352.

[61] § 101(31)(B)(iii).

present in the transaction's outcome. The successful lenders had substantial stakes in the outcome of the bankruptcy and incentive to control the debt financing fate of the debtor. Those lenders accepted the super-priority lien with open arms. Second, the transaction was undertaken to solve significant liquidity issues facing Serta, arguably in anticipation of filing for bankruptcy, which occurred two and a half years later.[62] Although the bankruptcy filing was not made within days or weeks of the transaction, Serta had been courting debt restructuring bids from two different creditors[63] to get the best deal to set up future restructuring plans. As mentioned before, courts can make a finding of fraud based on the presence of a combination of any of the badges. The combination of badges illustrated here indicates that a court applying this analysis could have found the transaction fraudulent and prevented it, maximizing the estate's value. Although the badges of fraud are a useful tool for courts to assess fraudulent transactions, courts do not consistently utilize them, and creditors' faith in the bankruptcy system has been shaken as uptiering transactions have become more common.

Opportunities for debtors to favor particular groups of creditors through uptiering directly controvert the purported goal of bankruptcy to maximize the recovery value to all creditors. Low-priority secured creditors and unsecured creditors have "no reason to believe that the modifications to the credit agreements are expected to maximize the recovery of the . . . loan."[64] In his analysis of uptiering transactions in modern capital structures, Ryan Schloessmann posits that "the presumption that the debtholders are similarly situated and can trust the majority to act in everyone's shared interest no longer holds."[65] The uptiering phenomenon has become more common over the past several years. Including *Serta*, six uptiering transactions have been litigated since June 2020,[66] likely with more on the way as creditors on the losing side of the transaction mount stronger legal attacks. In the *TriMark* case, the losing creditors filed suit against the impending uptiering transaction, including fraudulent transfer claims, in an attempt to stop the transaction.[67] Though the court ruled against the petitioners on

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[62] *See* Serta Simmons Bedding, LLC v. AG Ctr. St. P'ship (*In re* Serta Simmons Bedding, LLC), 2023 Bankr. LEXIS 1479, *16–17 (Bankr. S.D. Tex. June 6, 2023).

[63] *See* Dick, *supra* note 37, at 1354–55.

[64] *See* Ryan Schloessmann, *Covenant Control: The Case for Treating Uptier Transactions as a Form of Corporate Control*, 90 U. CHI. L. REV. 1197, 1206 (2023).

[65] *See id.*

[66] *See id.* at 1199 (showing that suits have been filed against TriMark, Boardriders, TPC Group, Revlon, and Wilmington Savings Fund).

[67] *See* Gerard S. Catalanello et al., *Financial Restructuring & Reorganization*

their fraudulent transfer claims,[68] their breach of contract and implied covenant of good faith claims remained intact, and TriMark ended up settling the case with the plaintiff, failing to establish precedent for preventing uptiering exchanges.[69] Like in *TriMark*, the New York Supreme Court upheld a challenge to an uptiering exchange in *Boardriders* brought by non-participating lenders for breach of the implied covenant of good faith by attempting the uptiering transaction.[70] The unsecured creditors committee in *Revlon* filed a similar challenge to a proposed uptiering transaction on the eve of bankruptcy that would promote preexisting lienholders to first priority at the expense of the lower-tier creditors in exchange for DIP financing.[71] The courts' rulings in these cases suggest a willingness to allow minority creditors to challenge these transactions, although more widespread scrutiny is needed before low-priority and unsecured creditors can feel most protected.

Uptiering exchanges allow debtors to shift their priority levels, leading to favorable treatment of a particular creditor. As noted, debtors in the past decade have more frequently used uptiering to obtain financing from their preexisting debtors. This creates an investment opportunity for savvy PE groups and creditors looking to insert themselves into the top of a company's secured creditor priority ranking. However, creating a new class of super-priority creditors is not the only way debtors leverage valuable incentives to entice DIP financiers.

B. Trapdoor Transactions

In addition to uptiering, 'trapdoor' or 'drop-down' transactions are becoming more commonplace in light of modern capital structure developments. Trapdoor transactions transfer valuable collateral of the distressed company outside the reach of preexisting creditors to obtain new debt.[72] The collateral then becomes

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Advisory: TriMark: Are "Sacred Rights" Still Sacrosanct?, ALSTON & BIRD (Sept. 10, 2021), https://www.alston.com/en/insights/publications/2021/09/trimark-are-sacred-rights-still-sacrosanct [https://perma.cc/CJN9-UJ9W].

[68] *Id.*

[69] *See* Elliot Ganz, *TriMark Settles: What Does That Mean for the Loan Market?*, LSTA (Jan. 12, 2022), https://www.lsta.org/news-resources/trimark-settles-what-does-that-mean-for-the-loan-market/ [https://perma.cc/AXS9-VDLY].

[70] *See* Josh Friedman, *Boardriders Minority Lenders Notch Initial Victory Challenging Uptier Transactions*, A&O SHEARMAN (Oct. 19, 2022), https://www.jdsupra.com/legalnews/boardriders-minority-lenders-notch-5910453/ [https://perma.cc/6LFB-WR38].

[71] *See In re* Revlon, Inc., No. 22-10760 (DSJ), 2023 WL 1998864 *12–13 (Bankr. S.D.N.Y. Feb. 14, 2023).

[72] *See* Dick, *supra* note 37, at 1363.

property of a subsidiary, allowing the transferring company to sequester the lower-value assets encumbered by preexisting liens and leverage the new subsidiary holding the valuable collateral free of preexisting liens, pledging the transferred collateral as security for new debt. As debtors have embraced the complexities of modern corporate structures through establishing corporate subsidiaries, greater opportunities to shift assets between corporate units have presented themselves. These types of transactions, on their face, would seem offensive to secured creditors with claims against what they thought were valuable assets, but come to find out, those valuable assets are no longer available to satisfy their claim if the company were to default.

This revelation came true for secured creditors of J. Crew in what turned into one of the most notable examples of trapdoor provisions.[73] J. Crew's managers devised a plan to transfer the company's valuable intellectual property (valued at around $250 million) to a subsidiary to obtain new loans secured by the now unencumbered valuable collateral.[74] Upon learning of the transfer, creditors appointed a new administrative agent who, in response to J. Crew's suit for declaratory judgment approving the transfer, claimed that the transfer was fraudulent.[75] While the suit was pending, J. Crew persuaded junior creditors to exchange debt for new secured bonds on different terms and received senior creditor-approval for the transaction.[76] Minority creditors filed one final suit to prevent the transaction, again citing fraudulent transfer claims, but the court rejected their argument, primarily because of the substantial majority of creditors backing the transaction and dismissing the action.[77]

Much like uptiering exchanges, trapdoor transactions carry with them the presence of badges of fraud. First, as seen in *J. Crew*, these transactions allow debtors, at the behest of their need for capital (and the presence of hungry debt financiers), to shift precious collateral from a liability-burdened entity to a seemingly invaluable one with no preexisting creditors. For a nearly insolvent debtor planning for Chapter 11, this transfer would amount to moving a substantial portion of the debtor's valuable assets.[78] Second, once these assets have been cleared of their liability counterparts, they are leveraged to obtain new super-priority debt financing from none other than the preexisting creditors looking to move up in the priority line. These creditors exert significant control over DIPs

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[73] *See id.*

[74] Skeel, *supra* note 34, at 2109–10.

[75] *See* Dick, *supra* note 37, at 1363.

[76] *See id.* at 1365.

[77] *See id.*

[78] Unif. Voidable Transaction Act § 4(b)(5).

and should easily be considered insiders for fraudulent transfer and badge of fraud purposes.[79] The shifting of these assets to the subsidiary also resembles removing or concealing the assets because the collateral, in the hands of the subsidiary, is beyond the reach of preexisting creditors' liens.[80] Further, the transaction was undertaken to obtain additional financing for J. Crew, with their bankruptcy petition filed after the transaction took place, suggesting J. Crew was either insolvent at the time of the transaction or became insolvent shortly thereafter.[81] Not to mention, the transfer presupposed the use of valuable intellectual property as collateral for new loans outside of their existing debt structure.[82]

Ultimately, the *J. Crew* court approved the trapdoor provision and did not find fraud. However, the presence of these badges suggests that under greater scrutiny and less deference to the preferred creditors of the DIP, the court could have reasonably found differently and rejected the transaction, increasing the value of the estate. As creditors become more wary of actions taken by debtors and other creditors, applying the badges of fraud will aid in uncovering these transactions sooner and increase enforcement of the fraudulent transfer provisions in the Code. Unfortunately for creditors, court approval of trapdoor provisions like that in the J. Crew bankruptcy seems to be catching steam.

Trapdoor provisions, though coming into the limelight with *J. Crew*, have quickly become a bankruptcy staple, mimicked by other insolvent companies in need of cash. Caesars and Revlon have undertaken similar transactions in recent years to obtain new funding.[83] The Caesars bankruptcy began with a proposal from two PE owners of Caesars to transfer certain projects out of Caesars Entertainment Operating Co. Inc., the debt-burdened subsidiary of parent company (and debtor) Caesars Entertainment Corp.[84] Caesars' PE investors planned to provide $500 million to buy projects. This resulted in the sale of major Las Vegas casinos, like the LINQ Hotel and Planet Hollywood, to other Caesars subsidiaries.[85] These transactions deprived creditors of valuable collateral backing their loans, placing these assets beyond their reach and sparking claims of fraud against the debtor.[86]

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[79] Unif. Voidable Transaction Act § 4(b)(1).

[80] Unif. Voidable Transaction Act § 4(b)(7).

[81] Unif. Voidable Transaction Act § 4(b)(9).

[82] Unif. Voidable Transaction Act § 4(b)(10).

[83] *See* Skeel, *supra* note 34, at 2110–11; Dick, *supra* note 37, at 1366.

[84] *See* Tom Hals & Tracy Rucinski, *How Buyout Firms Have 'Cake and Eat it Too' in Caesars Bankruptcy*, REUTERS (Oct. 4, 2016, 10:30 AM), https://www.reuters.com/article/idUSL2N1CA18K/ [https://perma.cc/8UBB-6RSN].

[85] *See id.*

[86] *Id.*

Although disgruntled creditors made strong challenges to the trapdoor transactions, the debtor and these angry creditors agreed to drop their fraudulent transfer suits and allow Caesars to exit bankruptcy.[87] In *Revlon*, the debtor undertook a similar transaction to that in *J. Crew*, transferring a portion of their intellectual property from the debtor to a newly formed subsidiary, where it could not be reached by the preexisting senior secured liens.[88] The intellectual property was leased back to the debtor for their continued use, while it was used as collateral to secure new loans.[89] Revlon succeeded in their trapdoor provision not just once, but also did so again less than a year later, shifting more intellectual property to their subsidiary to be used as collateral.[90] Over 50% of Revlon's creditors banded together to fight the transfer of the intellectual property, eventually filing a lawsuit.[91] They claimed the transaction was a fraudulent transfer, but the suit became moot because of an error. This error resulted in all senior secured liens being paid in full, which failed to establish the trapdoor transfer as fraudulent transfer precedent.[92]

Though known as an example of the uptiering exchange, *Serta* also featured an attempted trapdoor transaction like those in *J. Crew*, *Caesars*, and *Revlon*. Although it was not the winning proposal, the losing group of creditors in *Serta* pitched a trapdoor provision to the debtor as their preferred method of debt financing.[93] The *Serta* trapdoor proposal advocated transferring 30% of the company's most valuable collateral away from the debtor to secure loans supplied by the pitching creditor group.[94] The struggle between creditors to gain an advantage in DIP financing is exemplified by the comparison of the uptiering and

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[87] *Id.*; Controversially, the PE investors of Caesars, who advocated for the trapdoor transaction and largely controlled the debtor through bankruptcy, were allowed to retain ownership of 16% in the 'new' Caesars after it emerged from bankruptcy. Although these investors were called out for their fraudulent transfers, they emerged as winners, retaining equity in the new debtor, a rare feat for equity owners of the prepetition debtor because of the Code's strict "absolute priority rule." *See* Tracy Rucinski, *Caesars Wraps Up $18 Billion Bankruptcy Case, Eyes Future*, REUTERS (Jan. 17, 2017, 1:37 PM), https://www.reuters.com/article/idUSKBN1512WR/[https://perma.cc/5PX9-LGBW]; 11 U.S.C. § 1129(b)(2)(C)(ii).

[88] *See* Dick, *supra* note 37, at 1366.

[89] *See id.*

[90] *See id.* at 1367.

[91] *See* UMB Bank, Nat'l Assoc. v. Revlon, Inc., No. 1:20-cv-06352 (S.D.N.Y. Aug. 12, 2020).

[92] *See* Dick, *supra* note 37, at 1368.

[93] *See* Dick, *supra* note 37, at 1355.

[94] *See id.*

trapdoor proposals present in *Serta*. This indicates how comfortable creditors are with utilizing these proposals and their little concern for successful fraudulent transfer actions against them. As corporate complexity and financing techniques become even more complex, companies, especially those anticipating needing DIP financing, will continue to develop more intricate ways to finance their operations earlier and earlier in their insolvency planning.

C. Comparison of Uptiering and Trapdoor Provisions

Although the structure and process of uptiering exchanges and trapdoor provisions are different, they are similar to the financial motivations of DIP lenders and carry the marks of fraudulent transfers. In an uptiering exchange, when an additional tier of secured creditors is created with higher priority than existing creditors, the transaction functions to constructively defraud preexisting creditors who have already laid legitimate claims to their priority in repayment. DIP lenders, especially those providing leveraged loans to debtors, are encouraged to attempt to undertake these transactions with debtors at the first signs of potential insolvency so they can secure repayment of their loans. This pushes these creditors to attempt to extract control from debtors before a bankruptcy petition through prepackaged bankruptcies in exchange for DIP financing.

Similarly, the process of transferring the valuable collateral and assets of the distressed company away from the parent company in a trapdoor transaction functions to actually and constructively defraud preexisting creditors to the benefit of the DIP lender. Debtors are able to defraud their creditors by hiding their valuable assets and diluting the value of their existing loans by bringing a super-priority creditor providing DIP financing over their preexisting liens. Further, this allows them to undertake a transaction with a new subsidiary, potentially for less than the equivalent value of the assets, amounting to a constructive fraudulent transfer. DIP lenders are incentivized to undertake these transactions for the same reasons as an uptiering exchange – their status as the first-in-line creditor can be secured by providing additional funding to jump the line. As debtors continue to take advantage of these and other creative ways to assert themselves above other creditors, courts and other creditors must act to prevent the damage caused by these transactions. However, one issue not solved by a successful fraudulent transfer action remains: the insider-like nature of the DIP financiers orchestrating the transaction.

D. Insider Control Baked into the Bankruptcy Process

A common theme between uptiering and dropdown transactions is distressed companies' motivation in undertaking the transactions. When faced with potentially imminent bankruptcy, management knows there will be a continued

need for financing to keep the business running, something hard to come by if you have filed for bankruptcy. Soon-to-be debtors are incentivized to tee themselves up for a successful exit from bankruptcy as much as possible. However, this is not one-sided. Despite what much DIP financing literature asserts, the creditors as much as, if not more than, debtors are the proverbial sharks in the waters of secured DIP lending. As noted earlier, the modern capital structure of companies entering bankruptcy has changed significantly. The DIP financing market created by financial institutions has moved outside the banks and into the sights of PE firms.

PE-ownership of some secured claims is just the tip of the iceberg. As of 2020, approximately 70% of Moody's-rated distressed companies were owned by PE.[95] PE firms have utilized this model of providing capital to distressed companies in exchange for secured debt, inserting themselves strategically into the incoming bankruptcy process. Further, the foresight of PE firms to scout and invest in the best possible targets gives them a leg up in the bankruptcy process sale that will occur immediately preceding a Chapter 11 petition. Debtors looking to escape bankruptcy unscathed can easily fund their firm through DIP lending from PE, but only if they give up substantial control of the bankruptcy process to the lender. Further, the opportunity for PE firms to purchase a secured stake in a distressed company, move their secured claim ahead of all of the other preexisting creditors, and obtain control over the timeline and outcome of the bankruptcy process should raise significant red flags for unsecured and low-priority creditors.

Unfortunately, because debtors are incentivized to work with the DIP financier, those parties are unlikely to take advantage of any potential fraudulent transfer claim since the super-priority lender has the greatest chance of the most significant recovery from bankruptcy. Though other creditors can attempt to file fraudulent transfer claims to increase the value of the bankruptcy estate and undo trapdoor provisions or other suspect transfers, that value, if recovered, goes to the higher prior lienholders.[96] Courts have signaled, as seen in *J. Crew*, that when a

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[95] *See* Mayra Rodriguez Valladares, *Over Half of Rated Company Defaulters Are Owned by Private Equity Firms*, FORBES (July 16, 2020, 5:32 PM), https://www.forbes.com/sites/mayrarodriguezvalladares/2020/07/16/over-half-of-rated-company-defaulters-are-owned-by-private-equity-firms/?sh=6abcaa8c7b1c [https://perma.cc/2TQ8-QQ3P].

[96] *See* 11 U.S.C. § 364; *see also* 11 U.S.C. §507(a)(2). DIPs give DIP lenders several priority benefits in exchange for their DIP financing, often resulting in the DIP lender being paid before other preexisting creditors. DIPs may offer DIP lenders administrative priority in exchange for their loan under § 364(a)–(c). Administrative priority under § 364(c) entitles the DIP lender to be paid first out of all administrative claims, which are already

majority of creditors eventually consent to the transaction, fraudulent transfer claims by unsecured creditors are not likely to be found, locking in the priority benefits that DIP lenders negotiated for.[97] Fortunately, the harms caused by these transactions could be lessened through changes in how the Code and fraudulent transfer law work together.

IV. RECOMMENDATIONS FOR MITIGATING THESE ISSUES

Although DIP financing presents a variety of opportunities for savvy financiers to take advantage of and undertake these pseudo-fraudulent transfers, several measures can be put in place to mitigate their effects. The control DIP financiers exert over debtors begins far in advance of the petition date, requiring various changes to quell any potential for fraud as early in the road toward bankruptcy as possible. This includes measures taken in conjunction with the Code and others that operate outside of the scope of bankruptcy to give debtors additional protection. Possible solutions range from less to more disruptive in their implementation and oversight, providing different tools to solve these issues. The least disruptive solution is to broaden the Code's definition of "insiders" to include major creditors of the debtor and other substantially controlling parties as "person[s] in control of the debtor."[98] Beyond changing Code provisions, adopting uniform fraudulent transfer laws across the states and the Code would eliminate discrepancies in fraudulent transfer enforcement. The most complex solution to prevent DIP lenders from starting down the path of suspect transactions is to create stronger regulatory scrutiny over creditors outside of bankruptcy through a new watchdog agency. Although these recommendations differ in scope and application, they can be utilized individually or in combination to prevent fraud.

A. Expanding the Definition of "Insider"

Transfers to insiders by bankruptcy debtors in the lead-up to bankruptcy are heavily scrutinized by courts. Transfers made to preferred insiders in the year prior to a petition are subject to potential preference[99] and fraudulent transfer actions[100] to claw back those ill-given funds. In its current form, however, the Code excludes

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paid out second under § 507(a)(2) priority. DIPs also can offer new liens on unencumbered property, creating a first-in-line claim over the collateral for the lender per § 364(c)(2). DIPs also can give out senior liens on already encumbered collateral per § 364(d), further increasing the likelihood of recovery before other creditors by DIP lenders.

[97] *See* Dick, *supra* note 37, at 1365.

[98] 11 U.S.C. § 101(31).

[99] 11 U.S.C. § 547(b)(4)(B).

[100] 11 U.S.C. § 548(a).

these creditors from the definition of "insider," enabling them to slide past preference actions by subjecting their transactions with the debtor to only a ninety-day scrutiny period.[101] Though trustees and debtors are well equipped to handle these transactions, parties considered to be insiders are limited and are not encompassing enough to fully protect debtors and creditors. As discussed in Part II.A, insiders for corporate debtors are directors and officers of the debtor, *someone in control of the debtor*, members of a partnership that includes the debtor as a partner, general partners of the debtor, and relatives of any of these parties.[102] This definition contemplates many of the people closest to the debtor, such as high-ranking employees of the debtor and their relatives. Still, it fails to describe or define how much control one must have over the debtor to be considered an insider.

As evidenced by the modern DIP financing market and aggressive tactics PE and other creditors take to establish themselves as the first-in-right creditor, the Code's failure to include creditors pushing debtors to undertake these modern transactions as insiders misses the mark. Controlling creditors attempt to restructure creditor priority through uptiering exchanges, obtain liens over valuable collateral in new subsidiaries in trapdoor transactions, and require debtors to agree to highly controlling RSAs just to obtain necessary bankruptcy financing. These creditors hold a firm grip on debtors, often through bankruptcy milestones or financing terms,[103] dictating their every move before and during bankruptcy. This control mimics the authority directors of the debtor have to make changes to the debtor's financing scheme and alter the priority rights of preexisting creditors. DIP lender control is clearly similar to that exercised by "insiders" defined by the Code, so it is a logical next step to include these types of creditors in the definition of insider. It could be argued that "control over the debtor" expressly includes these powerful creditors. However, given the freedom courts give them to undertake these suspect transactions with little scrutiny, expressly expanding the definition of insiders to include creditors who attempt to or succeed in taking over the bankruptcy process from the debtor is warranted. This change to § 101(31)(B) would be easy to implement and would give creditors and the courts additional teeth to challenge and enforce fraudulent transfer laws in Chapter 11 cases.

B. Uniform State Fraudulent Transfer Laws

A more complex solution to these issues is to address gaps in state fraudulent transfer laws to level the playing field debtors face in Chapter 11 proceedings. Given the varied adoption of fraudulent transfer laws across the United States and

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[101] 11 U.S.C. § 547(b)(4)(A).
[102] *See* 11 U.S.C. § 101(31)(B).
[103] *See infra* Part III.

a general trend of development beyond the Code, establishing uniform fraudulent transfer laws would provide much-needed consistency. As noted in Part I, each state's adopted version of fraudulent transfer law has different look-back periods, allowing savvy debtors to file their petitions in the most favorable jurisdiction. This variance in lookback periods also means that a recoverable fraudulent transfer in Michigan (six-year period)[104] may not be recoverable in New York (four-year period)[105], depending on when recovery is pursued. As companies increasingly provide leniency to and cooperate with lenders representing high priority claims before bankruptcy petitions are filed, these suspect transactions can escape any scrutiny by interested parties and the courts. Creating uniform fraudulent transfer laws across the states would prevent debtors from being pushed to file in jurisdictions with the shortest lookback periods by their creditors and allow for even application of the law, maximizing recovery for the estate.

In addition to uniform lookback periods, additional strength should be given to the badges of fraud in finding actual or constructive fraud. In their current form, the badges provide an optional avenue, and courts often undertake their own investigation into whether a transfer is fraudulent or not. This gives debtors an additional reason to find the jurisdiction that suits them, forum-selecting judges with the most favorable analysis to their debtor restructuring plan. Establishing the badges of fraud as the primary test for analyzing fraudulent transfers would create greater uniformity to fraudulent transaction suits, providing debtors and creditors with a reasonable expectation of what constitutes fraudulent activity. Ease of use in a wide range of situations and the ability of courts to rely on any combination of these badges allows for contained judicial deference and a more consistent application of the law.

Beyond implementation of uniform state laws and codes, another possible solution would be to reform venue rules so that debtors are unable to forum shop and take advantage of local rules that hurt the estate and creditors. The impact of forum shopping on the filing of bankruptcies is well documented,[106] indicating that creditors would benefit from stricter requirements on petitioning debtors. Easy implementation of new venue rules, uniform fraudulent transfer laws, and the badges of fraud analysis allow regulators to enact one proposed change, or a

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[104] *See* Mich. Comp. Laws Serv. § 566.39(A) (LexisNexis 2023); *see also* Mich. Comp. Laws Serv. § 600.5813 (Michigan's lookback period for fraudulent transfer actions is six years).

[105] *See* N.Y. Debt. & Cred. Law § 278(a) (Consol. 2023) (New York's lookback period for fraudulent transfers is four years).

[106] *See* Jared A. Ellias, *What Drives Bankruptcy Forum Shopping? Evidence from Market Data*, 47 J. OF LEGAL STUD. 119, 120 (2018).

combination of them, as each attempt to close current loopholes. Although outside the scope of this paper, further inquiry into potential changes to the venue rules would further promote the goals of bankruptcy while disincentivizing bad behavior by debtors in cahoots with their to-be DIP financiers.

C. Greater Scrutiny of Creditors During and Prior to DIP Financing

Recognizing and supporting the business decisions of American companies is an advent of statutory schemes governing business. Throughout the Code, courts defer to the business judgment of debtors[107] in their many powers, such as assuming or rejecting executory contracts.[108] However, as seen in the modern business landscape, poor-credit companies are requiring the services of PE debt financiers even earlier than before.[109] Unfortunately for preexisting creditors, there is little recourse against predatory loans offered by predatory lenders until the bankruptcy is filed, where there is no guarantee that the court will overturn suspect uptiering or dropdown transactions.[110] The lack of actionable steps for creditors to scrutinize these transactions and the missing oversight from courts prior to a bankruptcy petition creates a shortfall that lenders are inclined to take advantage of.

One possible solution is creating an out-of-bankruptcy watchdog organization to take the place of the U.S. Trustee *before* debtors file their petitions. Much like how the Federal Trade Commission investigates potential antitrust issues stemming from mergers and acquisitions, this new governmental body would be tasked with protecting the rights of existing creditors while ensuring that new leveraged lenders are not positioning themselves as "insiders" with an intent to defraud. The organization can rely on a combination of publicly available information and reported malfeasance by debtors and creditors in their investigations into suspect transactions. Currently, the financial disclosures of each publicly traded company reveal debts and obligations. Existing reporting laws could be updated to mandate broader reporting of new, high priority secured debt taken on by the debtor. Further, the organization would solicit complaints from existing creditors concerned about the introduction of new creditors to imminently insolvent debtors over whom they have liens. Existing notice requirements for secured liens and any potential changes to the structure of existing liens should put

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[107] *See In re* Modi, 2023 Bankr. LEXIS 1505, at *11 (Bankr. N.D. Ga. June 8, 2023).

[108] *See In re* Miller, 2016 Bankr. LEXIS 1046, at *10–11 (Bankr. D. Mont. Apr. 1, 2016) (citing 3 COLLIER ON BANKR., ¶ 365.03[2] that "[T]he court should focus on the business judgment of the trustee or debtor in possession. . . .").

[109] *See infra* Part III.

[110] *See infra* Part IV.A.

existing creditors on notice of potential pre-packaged bankruptcies funded by these newfound creditors, giving concerned parties a basis to report suspect transactions. The goal of the organization would not be to automatically undo or prevent new investments into companies, but rather to increase scrutiny of the types of investments made earlier in the process to detect potential fraudulent transfers sooner. One of the main reasons these types of transactions have become so ubiquitous in modern bankruptcy is PE's perception that the courts will not stop their attempts. This hubris, paired with the desperation of newly insolvent debtors to obtain DIP financing and preserve their companies, creates the perfect opportunity to take advantage of debtors. This suggested organization would act as a friend to creditors and debtors alike to push back against the aggressive investors and creditors long before these transactions are baked into the bankruptcy process and cannot feasibly be undone.

One downside to this suggestion is the logistics of establishing a new federally funded organization and the associated costs. Additionally, ensuring that the organization has the authority to act and prevent fraudulent transfers is critical, given the importance of enforcement in managing the issue at hand. Nevertheless, the broader goals of modernizing fraudulent transfer law, closing loopholes currently afforded to creditors to benefit themselves at the expense of other creditors, and ensuring the maximum value of the estate in bankruptcy would be served by creating such an organization. This complex solution would function as the most potent weapon against today's fraudulent transfers. As PE grows more and more aggressive and the market for leveraged loans continues to expand, preventing the dilution of legitimate secured creditors from these modern leveraged buyouts will ensure that when the target corporation does ultimately file for bankruptcy, the value of the estate is maximized, and the interests of low-priority and unsecured creditors are protected.

D. Recommendations Evaluation

Each of these recommendations attempts to mitigate parts of the problems caused by the current arrangement of DIP financing to better preserve and maximize the bankruptcy estate. They intend to prevent fraud against all parties implicated in the bankruptcy by allowing for progressively greater disruption of these laws and are meant to be implemented in concert or individually. Smaller changes like broadening the definition of "insider" provide bankruptcy participants with a more robust tool against fraudsters without completely upending the PE markets as we know them. On the other hand, creating a strong body to oversee predatory investing tactics earlier than they are presently being observed presents the earliest possible detection. It is also the costliest solution and requires

substantial support from practitioners and the legislature alike. Ideally, a combination of these recommendations would be adopted, but any one solution would enhance enforcement against fraudulent transfers and would benefit both debtors and their stakeholders. Furthermore, these recommendations provide a starting point for continued research and scholarship to address what other updates to bankruptcy laws can be made to better interact with the modern complexities of the financing markets and ever-evolving strategies employed by debtors in Chapter 11 cases. Collateral issues in bankruptcy venue often are a catalyst for the issues at hand, providing the basis for greater scrutiny of the current venue system and call for reform. Bankruptcy and fraudulent transfer law push to maximize the value of the bankruptcy estate while preventing frauds committed against it and other creditors. It is time to give those stakeholders the tools necessary to satisfy those goals and challenge those who try to game the system.

V. CONCLUSION

Opportunities to take advantage of desperate debtors far before bankruptcy petitions have been filed and the opportunity to place themselves atop the creditor priority scheme have given rise to insider-like creditors dominating during bankruptcy. Through uptiering, trapdoors, RSAs, and other creative instruments, these insiders can restructure debtors at their discretion. Jurisprudence in recent Chapter 11 cases has shown judicial acceptance of this trend, harming creditors and damaging estate value. Often, these insider creditors act far before bankruptcy, shielding them from inquiries about fraudulent transfer actions and embedding themselves as the controlling party of the debtor during bankruptcy. Further scholarship regarding correlated issues surrounding bankruptcy, such as venue reform and stakeholder appetite for fraudulent transfer reform, can expand on this paper's proposed recommendations to round out the modernization of these laws and work towards the goals espoused here.

Although changes are required, this paper suggests that a combination of expanding the Bankruptcy Code to better enforce these suspect transactions and larger organizational change outside of bankruptcy be employed to combat these issues. These incremental changes will allow for scrutiny earlier along in the process, which will benefit all stakeholders in Chapter 11. This paper functions as the continuation of a conversation regarding bankruptcy reform, inviting both incremental and more significant changes to jump-start this process.