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Parting Advice: Judge Drain Rules That Dividends Paid From the Proceeds of Safe-Harbored Transactions Are Not Safe-Harbored in In re Tops Holding II Corp.

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*By: **Mark E. Dendinger** and **Jonathan Lozano***

In his final opinion, Judge Robert D. Drain of the United States Bankruptcy Court for the Southern District of New York held that dividends paid from proceeds of safe-harbored transactions under section 546(e) of the Bankruptcy Code are not safe-harbored. While only approximately 15 pages of Judge Drain's 109-page final opus are dedicated to consideration of the section 546(e) issue, the relevant analysis ends with a pressing question to Congress and an appeal to modify section 546(e) to "restrict to *public transactions* its currently overly broad free pass . . . that has informed the playbook of private loan and equity participants to loot privately held companies to the detriment of their non-insider creditors with effective impunity."**[1]** The logic of the opinion poses a clear hurdle to private equity participants looking to protect their dividends by arguing that such dividends are part of an integrated transaction that is otherwise safe-harbored under section 546(e).

The salient facts leading up to the opinion are as follows: debtor Tops II Holding Corporation ("Tops") owned and operated 169 supermarkets in upstate New York, northern Pennsylvania and Vermont, employing about 14,000 people, including 12,300 union members. In 2007, a group of private investors (the "PE Group") acquired the stock of Tops' predecessor for approximately $300 million, $200 million which was funded with secured debt incurred by Tops.

Known to the PE Group, in 2007 Tops' financial health was questionable due to its significantly underfunded pension plan, for which Tops' withdrawal liabilities grew from $85 million in 2007 to over $515 million in 2013. During the same six years under the PE Group's controlling ownership, Tops' funded debt also grew from $227 million to $649 million. Despite these growing contingent and funded liabilities, Tops paid four dividends (2009, 2010, 2012 and 2013) to the PE Group totaling $375 million funded from (a) the proceeds of secured loans and (b) severely restrained capital expenses. After receiving their final dividend in 2013, the PE Group entered into a purchase and sale agreement under which they sold their stock to an entity controlled by Tops' senior management for approximately $16.6 million (of which Tops funded $12.3 million and management funded $4.3 million).

Tops filed for bankruptcy in February 2018 and the Court confirmed Tops' chapter 11 plan approximately nine months later, pursuant to which Tops terminated one of its pension plans and settled another, leaving over $1 billion in creditor claims left to recover from a litigation trust which included potential avoidance actions surrounding the payment of dividends to the PE Group. The trustee for the litigation trust (the "Trustee") subsequently filed a complaint against, among others, the PE Group seeking to avoid the dividends as actual and constructive fraudulent transfers under sections 273-275 of New York's Debtor and Creditor Law and sections 544(b) and 550 of the Bankruptcy Code. The defendants filed motions to dismiss asserting, in addition to defenses of solvency, lack of fraudulent intent (where applicable) and the complaint being time-barred, that the dividend payments to the PE Group were safe-harbored under section 546(e) of the Bankruptcy Code, which provides:

> Notwithstanding sections ***544***, ***545***, ***547***, ***548(a)(1)(B)***, and ***548(b)*** of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section ***101***, ***741***, or ***761*** of this title, or settlement payment, as defined in section ***101*** or ***741*** of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under ***section 548(a)(1)(A) of this title***.

The PE Group contended that the dividends were exempt because (a) they were made in connection with private offerings for notes, the proceeds of which were used, in part, to fund each dividend, and such offerings were "securities contracts" as defined in section 741(7) of the Bankruptcy Code; and (b) they were transfers by a qualifying "financial institution" as defined in section 101(22)(A) of the Bankruptcy Code because they were made by Tops through its bank to the PE Group's banks, which were acting as either Tops' or the PE Group's agents or custodians and were therefore the parties' "financial institutions."

The Court held the action was not time-barred and that Tops was solvent at the time of each of the dividends.***[2]*** Importantly, the Court also undertook a careful analysis of the PE Group's safe harbor argument. The Court described the entire transaction—beginning with the notes offerings and ending with the dividend payments—as a series of transactions with the notes offerings constituting only a subset of the entire transaction and the dividend payments constituting another subset in the series. The Court first determined that the dividends were not safe harbored under section 546(e) because the dividends were very clearly not settlement payments in respect of a securities contract, as they were simply one-way payments for which Tops received nothing. In contrast, the Court noted that a "settlement" in the context of the securities industry "refers to the completion of a securities transaction" and a "settlement payment" is "an exchange of money or securities that completes a securities transaction."***[3]*** Citing to *Merit Mgmt. Grp. V. FTI Consulting, Inc.*,***[4]*** the Court held that even if section 546(e) were to apply to the notes offerings as a specific transaction in a series of transactions, the dividend payments would not be automatically exempt as well.

In response to the PE Group's argument that the dividends were safe harbored because they were but one element of an *integrated* transaction that started with the safe-harbored notes offerings, the Court again relied on *Merit Mgmt.* in determining that the *challenged* transaction must be shown to fit within the safe harbor (rather than merely being a subset of a safe-harbored transaction).***[5]***

Looking next to the PE Group's argument that the parties' banks were agents or custodians for the purposes of section 546(e), the Court held that the PE Group had not identified an agency or custody agreement between (a) a financial institution, as defined in section 101(22)(A) of the Bankruptcy Code, and (b) either Tops or the PE Group, which, if it were the customer of such a financial institution under an agency or custody agreement, would itself be deemed a financial institution. In arguing the presence of a custodial relationship, the PE Group produced certain flow of funds memoranda showing the flow of funds from one of the book running managers into Tops' bank account and thereafter from Tops to one of the PE Group member's bank accounts. The Court held, however, that the flow of funds memoranda was merely evidence of a creditor-debtor relationship, rather than of agent and principal, and found it "unlikely that either the bank that received the private note consideration used to pay the dividends here or the banks that received the dividends were 'custodians' of Tops and the [PE Group], respectively, for purposes of section 101(22)(A) of the Bankruptcy Code. Unlike 'agent,' the term 'custodian' is separately defined in the Bankruptcy Code, and by its plain terms that definition clearly would not apply to a depositor/bank relationship."***[6]***

Following the Court's analysis of the section 546(e) issues, Judge Drain, noting that this would be his last opinion before retiring from the bench, issued an appeal to Congress to offer some clarity on the section 546(e) safe harbor that would flow from its intended purpose:

> As this is my last opinion before retiring from the bench, perhaps I can be indulged in asking, *why* Congress has put the courts to all this parsing and hair splitting over (a) whether a transaction is one or many and, if many, has the avoidable transaction has [sic] been properly identified, or (b) whether there is a qualifying participant that is a proper customer, agent, or custodian. After all, at issue here is a transaction whereby, after encumbering a privately held company's assets with privately issued debt, a handful of sophisticated private equity investors took massive dividends that, as asserted by the Complaint, left the pension plans of thousands of workers and hundreds of creditors holding the bag. Only the veracity of that last assertion – that is, whether Tops was insolvent or rendered insolvent by the dividends – not whether the dividends are safe-harbored, should be at issue. *The avoidance of these dividends and the loans that funded them would have no effect on the public securities markets, the ostensible purpose for section 546(e)*. On the other hand, the transfer avoidance provisions of the Bankruptcy Code are of fundamental importance, 'help[ing] implement the core principles of bankruptcy,' and go back to the enactment of the Statute of 13 Elizabeth in 1571. Given the importance of fraudulent transfer law in bankruptcy cases, Congress should act to restrict *to public transactions* its currently overly broad free pass in section 546(e) that has informed the playbook of private loan and equity participants to loot privately held

companies to the detriment of their non-insider creditors with effective impunity. [7]

Such an open plea is certainly uncommon among bankruptcy judges. While it is too early to tell whether Congress will acknowledge Judge Drain's request, the opinion may spell trouble for private parties receiving dividends from soon-to-be debtors. As a preliminary matter, any party receiving dividends prior to this opinion would already have *Merit Mgmt.* to contend with, which holds that any transaction sought to be avoided must be looked at individually, rather than depending on the surrounding transactions. While the aftermath of *Merit Mgmt.* produced *Boston Generating*, Judge Drain's disregard for the reasoning in *Boston Generating* may well resonate with other courts struggling to reconcile that decision with *Merit Mgmt.* Indeed, rather than grapple with any sort of analysis to determine whether a transaction or document was sufficiently integrated with a separate safe-harbored transaction, courts may find it easier to mirror Judge Drain's deference to *Merit Mgmt.*'s requirement that the transaction to be avoided itself be an exempt transaction under section 546(e).

[1] *Halperin v. Morgan Stanley Investment Management, Inc.* (*In re Tops Hldg II Corp.*), No. 20-08950 (RDD) (Bankr. S.D.N.Y. Oct 12, 2022) (the "Opinion")

[2] The Court agreed with the Trustee that the solvency opinions obtained by Tops were woefully deficient and were of no value in arguing that Tops was solvent. Opinion at 5.

[3] Opinion at 63 (internal citations omitted).

[4] 138 S. Ct. 883 (2018).

[5] The PE Group argued that *Holiday v. K Road Power Mgmt., LLC* (*In re Boston Generating LLC*), in which (a) a $975 tender offer for a stock and warrant buyback and (b) approximately $35 million in dividends, financed $2.1 billion of secured and mezzanine loans, were held to be exempt via Section 546(e), necessitated a finding that the dividends were exempt. 617 B.R. 442 (Bankr. S.D.N.Y. 2020). The Court attempted to reconcile *Boston Generating* with *Merit Mgmt* through three different rationales, including: (x) the *last* step of the series of transactions in *Boston Generating* was exempt (as opposed to the instant case where the first step was exempt); (y) the transaction documents in *Boston Generating* were so interdependent that there were no intermediate steps to the transaction; and (z) the subject transaction in *Boston Generating* was merely one step in a general plan that must be viewed as a whole. Ultimately, the Court, finding that the rationales would "turn[] *Merit Mgmt.* on its head," declined to follow it.

[6] Opinion at 71.

[7] Opinion at 72-73 (emphasis in original).