ALERTS

“It’s So Hard to Say Goodbye…”: Judge Drain Bids Farewell to Bench By Urging Congress to Curtail Section 546(e) Safe Harbor

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Four years after New York grocery chain Tops’ exit from Chapter 11, U.S. Bankruptcy Judge Robert Drain ruled that the Tops’ Chapter 11 trustee may proceed with litigation against certain private equity investors. The trustee alleged that the investors drove the company into bankruptcy by paying themselves more than $375 million in dividends while neglecting to address Tops’ unfunded pension liabilities. The ruling pushes back against what Judge Drain denounced as improper use of Section 546(e) of the Bankruptcy Code — an exemption that protects certain transactions from being unwound in Chapter 11 if they involve securities or commodities contracts — to defend against lawsuits over leveraged buyouts and private dividends.

Importantly, Judge Drain suggested directly to Congress a significant tightening of the Section 546(e) safe harbor in the last opinion of his two-decade career on the bench. Judge Drain argued that the safe harbor should apply only to public transactions so that private investors cannot use it to protect themselves, to the detriment of other creditors, if their transactions have no obvious connection to the public securities and commodities markets.

The investors have moved for leave to appeal Judge Drain’s decision to the U.S. District Court for the Southern District of New York. *Halperin v. Morgan Stanley Inv. Mgmt., Inc.* (*In re Tops Holding II Corp.*), No. Chapter 11, 2022 BL 364663, 2022 Bankr. Lexis 2899 (Bankr. S.D.N.Y. Oct. 12, 2022).

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I. Factual Background

In late 2007, a Morgan Stanley-led group of private equity investors purchased Tops for $300 million through a leveraged buyout. At the time of purchase, Tops was the largest participating employer in a multiemployer pension plan that was "significantly underfunded."

From 2007 to 2013, Tops paid $375 million in dividends to the investors that acquired it in the LBO. Secured debt and cutbacks in capital expenditure funded almost all of these payments.

Tops filed for bankruptcy in February 2018. Two years later, the Tops post-bankruptcy litigation trustee filed a complaint seeking to claw back the dividend payments made to Tops' private equity investors between 2007 to 2013 as constructive fraudulent transfers because they rendered the company insolvent. The investors who received the dividends claimed that the Section 546(e) safe harbor protected those dividends from clawback.

II. Fraudulent Transfer Law

The Bankruptcy Code allows bankruptcy trustees to avoid certain transfers made by debtors as fraudulent to facilitate preservation of estate assets. Congress intended these safe harbor provisions to level the playing field among creditors in the event improper prepetition transactions have drained a debtor of its valuable assets.

A bankruptcy trustee can avoid constructive fraudulent transfers if: (1) the debtor received less than reasonably equivalent value in exchange for the transfer; and (2) the debtor was insolvent at the time that the transfer was made or became insolvent as a result of the transfer, the transfer left the debtor with unreasonably small capital or the debtor intended to incur debts beyond its ability to pay. 11 U.S.C.

- 548(a)(1)(B). A trustee can also avoid fraudulent transfers under applicable state law.

Section 546(e) of the Bankruptcy Code affords a complete defense to constructive fraud claims if the requirements of the so-called "safe harbor" are satisfied. The Bankruptcy Code safe harbors transactions that are (1) "a transfer . . . in connection with a securities contract" that (2)

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is “made by or to (or for the benefit of)” a “financial institution.” 11 U.S.C. § 546(e).

III. Legal Analysis

Tops’ investors argued that Congress protected the dividend payments from avoidance under the Section 546(e) safe harbor — even though the dividends were not themselves safe harbored transfers — because they were partly funded by proceeds from a safe harbored offering of notes “securities contracts.” Further, the investors argued that the payments were transfers made by a qualifying “financial institution” because they were made by Tops’ bank to the investors’ banks, which banks were acting as Tops’ and the investors’ respective agents or custodians.

A. Qualifying Transaction

First, Judge Drain found that the dividends were not qualifying transactions under Section 546(e). Judge Drain relied on the Supreme Court’s ruling in *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.* where it stated, “the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid” and not any intermediary transfers. *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 888 (2018). Judge Drain stated:

“What clearly is not a ‘settlement payment’ in respect of a securities contract for purposes of section 546(e), however, is a dividend, and because it is the 2009, 2012, and 2013 dividends that the Complaint seeks to avoid . . . *Merit Mgmt*. requires that they not be safe-harbored under section 546(e). . . . Tops received nothing in exchange for the . . . dividends, whereas a . . . ‘settlement payment’ is an exchange of money or securities that completes a securities transaction. Thus, standing alone, the dividends would not constitute settlement payments for purposes section 546(e).”

Judge Drain elected not to collapse a series of transaction steps the recipients asserted related to the prepetition dividends, explaining that *Merit Mgmt* instructs courts to focus the safe harbor analysis on the specific transfer that the trustee seeks to avoid.

Judge Drain also questioned the practicality of determining when individual transfers in an multi- step transaction are sufficiently linked to warrant applying the safe harbor to the entire transaction. “Such

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line drawing," Judge Drain explained, "could easily rise to a nearly metaphysical dimension" and creates "clear potential for abuse."

B. Agents and Custodians

Second, Judge Drain found that the parties involved were not qualifying "financial institutions" under Section 546(e). Judge Drain acknowledged that the conduit banks facilitating the dividend payments might be "financial institutions." This could satisfy Section 546(e) if the banks acted as the parties' agents or custodians. However, the investors failed to identify any evidence of formal agency and/or custodial arrangements between the banks, on one hand, and Tops and the investors, on the other. "Without more," Judge Drain explained, "a bank account holder's relationship with its bank is merely a creditor-debtor relationship" and not that of agent and principal.

IV. Plea to Congress

Finally, in his last ruling before retiring from the bench, Judge Drain urged Congress to narrow significantly Section 546(e) of the Bankruptcy Code by making it applicable only to public market transactions. Judge Drain stated, "[t]he 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)." Judge Drain condemned the "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." Judge Drain continued, "[t]here is little doubt that the same playbook has been followed . . . and will continue to be followed unless Congress acts."

V. Key Takeaways

- Judge Drain's plea to Congress, if adopted, would greatly expand a trustee's avoidance powers and could have important ramifications for how parties structure leveraged buyout and restructuring transactions. This is especially true if they involve any form of dividend payments, which are, by definition, transfers without an exchange of reasonably equivalent

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- Even if Congress does not amend the Section 546(e) safe harbor, Judge Drain's ruling scrutinizes the structure of leveraged buyout and restructuring transactions in light of *Merit*. Judge Drain would not necessarily protect transfers under Section 546(e) simply because one or more elements of a multi-step transaction satisfies the safe harbor criteria. This diverges from long- considered practice of "collapsing" multi-stage transactions in certain bankruptcy analyses including avoidance

- Lastly, parties that intend to rely on the safe harbor must note the importance of properly drafted agency and custodial agreements and the role they play in a Section 546(e) analysis. Judge Drain's ruling clarifies that the absence of formal agency and custodial arrangements could prove fatal to a safe harbor

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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